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No.

IN THE

Supreme Court of the United States

CAPITAL ONE BANK (USA), N.A.,
F/K/A CAPITAL ONE BANK, AND CAPITAL ONE, N.A.,
AS SUCCESSOR TO CAPITAL ONE F.S.B.,

Petitioners,

v.

COMMISSIONER OF REVENUE OF MASSACHUSETTS,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Judicial Court Of Massachusetts

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

In *National Bellas Hess, Inc.* v. *Department of Revenue*, 386 U.S. 753 (1967), and *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992), this Court held that the Commerce Clause does not permit a State to impose a sales or use tax on out-of-state corporations that have no physical presence in the State, because such corporations necessarily lack the "substantial nexus" with the taxing State that is a constitutional prerequisite to the exercise of the State's power to tax the business activities of such out-of-state corporations. The question presented is:

> Whether the Supreme Judicial Court of Massachusetts erred in holding that a State may evade the "substantial nexus" requirement as explicated in *Quill* and *Bellas Hess* by imposing an income or excise tax on the very same out-of-state corporations that are constitutionally immune from sales and use taxes because they lack a physical presence in the taxing State.

PARTIES TO THE PROCEEDING AND RULE 29.6 STATEMENT

The parent company of petitioner Capital One Bank (USA), N.A. (formerly known as Capital One Bank) and petitioner Capital One, N.A. (the successor by merger to Capital One F.S.B.) is Capital One Financial Corporation, a publicly-traded corporation. There is no other publicly-held corporation that owns 10 percent or more of the stock of either petitioner.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

CASES

CONSTITUTIONAL PROVISIONS

STATUTES

RULES

OTHER AUTHORITIES

PETITION FOR A WRIT OF CERTIORARI

Capital One Bank (USA), N.A., formerly known as Capital One Bank, and Capital One, N.A., as successor to Capital One F.S.B., respectfully petition for a writ of certiorari to review the judgment of the Supreme Judicial Court of Massachusetts.

OPINIONS BELOW

The opinion of the Supreme Judicial Court of Massachusetts (App. 1a-22a) is reported at 899 N.E.2d 76. The opinion of the Appellate Tax Board (App. 23a-53a) is not published but is electronically reported at 2007 WL 1810723.

JURISDICTION

The judgment of the court below was entered on January 8, 2009. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL PROVISION INVOLVED

The Commerce Clause provides:

> The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.

U.S. CONST. art. I, § 8. The pertinent Massachusetts statutory provisions are reprinted in an appendix to this petition. App. 54a-69a.

STATEMENT

This case presents a recurring question of extraordinary significance to the Nation's economy. Notwithstanding this Court's holdings in *National Bellas Hess, Inc.* v. *Department of Revenue*, 386 U.S. 753 (1967), and *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992)—namely, that the "substantial

nexus" required by the Commerce Clause is absent when a State attempts to impose sales or use taxes on out-of-state corporations that have no physical presence in the State—a number of state appellate courts (including the Supreme Judicial Court of Massachusetts (SJC) below) have now held that States may easily evade that constitutional prohibition through the simple artifice of taxing the same economic activities by means of income or excise taxes instead of sales or use taxes. Growing numbers of state legislatures and tax collectors have chosen to follow that same course. The resulting heavy burdens on interstate commerce and disincentives for economic activity that reaches across state lines will continue to worsen absent this Court's intervention. Certiorari is warranted to ensure that the principles enunciated in this Court's decisions are not flouted by revenue-greedy States to the detriment of interstate business activities and, ultimately, the Nation's economy as a whole.

Further review is necessary in this case, for three reasons. First, the decision below is fundamentally inconsistent with this Court's explication of the "substantial nexus" requirement in *Quill*. That case reaffirmed the physical-presence requirement and held that a business "whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." 504 U.S. at 311. To be sure, *Quill* construed the "substantial nexus" requirement in the context of a use tax, but there is no principled basis for applying a different constitutional rule to other types of taxes so far as "substantial nexus" is concerned. The physical-presence requirement should govern the income tax at issue here, and there is no warrant for the SJC's contrary conclusion.

Second, the decision below sharpens a conflict among state appellate courts over state authority to tax out-of-state corporations with no in-state physical presence. While the SJC joins state courts that have artificially constricted *Quill* to the sales-and-use-tax context and adopted a vague economic-nexus approach for income taxes, other appellate courts have correctly understood *Quill* as a binding interpretation of the "substantial nexus" requirement that is fully applicable to income and excise taxes. The unacceptable result of that growing discord is that the meaning of the Federal Constitution shifts as business activity crosses borders, from States that respect physical presence to those that do not. This Court's review is necessary to resolve that conflict.

Finally, the decision below intensifies the already enormous practical difficulties that multistate businesses confront in ascertaining and satisfying their tax obligations to States with which they have no tangible connection. The problems posed by state departures from the physical-presence requirement have grown more severe since the last time this Court considered the issue two years ago, and indeed have been exacerbated by this Court's denial of review at that time. The time to decide the scope of *Quill* is now.

A. Commerce Clause Principles

This Court has repeatedly held that the Commerce Clause prohibits the States from unduly burdening interstate commerce. "The few simple words of the Commerce Clause . . . reflected a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Bal-

kanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation." *Hughes* v. *Oklahoma*, 441 U.S. 322, 325 (1979).

One burden that States are strongly tempted to impose is taxation that "imped[es] free private trade in the national marketplace." *Reeves, Inc.* v. *Stake*, 447 U.S. 429, 437 (1980). In *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977), this Court articulated the standard for evaluating when such state taxes violate the Commerce Clause. Under that test, a state tax is permissible only if the "tax [1] is applied to an activity with a *substantial nexus with the taxing State*, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Id.* at 279 (emphasis added).

This case concerns the application of *Complete Auto*'s "substantial nexus" requirement to state taxation of businesses that have no in-state physical presence. Before *Complete Auto*, this Court confronted such a tax in *National Bellas Hess, Inc.* v. *Department of Revenue of Illinois*, 386 U.S. 753 (1967), holding that a State could not impose a use tax on a mail-order company with no in-state physical presence. The Court explained that imposing sales and use taxes on out-of-state firms would place "unjustifiable local entanglements" on interstate commerce." *Id.* at 759-760.

In *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992), this Court eliminated any doubt that *Bellas Hess* retained its vitality when analyzed using *Complete Auto*'s "substantial nexus" terminology. The North Dakota Supreme Court had held that the State could impose a use tax on a mail-order office

supply retailer with no in-state outlets or personnel because, in its view, *Bellas Hess*'s bright-line requirement had been rendered "obsole[te]" by *Complete Auto* and "the tremendous social, economic, commercial, and legal innovations" that had taken place since *Bellas Hess*. *State* v. *Quill Corp.*, 470 N.W.2d 203, 208 (N.D. 1991). This Court reversed, reaffirming the physical-presence requirement. The Court held that the Commerce Clause's "substantial nexus" prerequisite is not satisfied when the nondomiciliary taxpayer has no property or personnel within the State, even though it may transact business with state residents through the channels of interstate commerce. 504 U.S. at 314-318.

B. Factual Background

1. At all times relevant here, petitioner Capital One Bank (now Capital One Bank (USA), N.A.) was a bank chartered and domiciled in Virginia that offered credit cards to its customers. App. 1a-3a. Petitioner Capital One F.S.B. (now Capital One, N.A.) was a federally-chartered savings bank that offered secured and unsecured credit cards and unsecured installment and consumer home loans. App. 3a. Petitioners issued general-purpose credit cards to Massachusetts residents as part of national marketing efforts. App. 3a-4a. Petitioners did not own or lease any real property in Massachusetts, nor did they own any other in-state property. App. 3a. Moreover, petitioners had no employees, agents, or independent contractors in Massachusetts. *Id.*

As members of Visa and MasterCard, two associations of banks, petitioners were "issuing banks" that issued credit cards bearing the "Capital One" name and branded with a Visa or MasterCard logo as appropriate. App. 4a-5a. Other members of the

associations served as "acquiring banks" that entered into contractual arrangements with merchants that accepted Visa or MasterCard. App. 6a-7a. Credit card transactions were enabled by the transmission of customer and bank information over electronic computer and telephone networks that cross state lines—that is, by the transmission of information through channels of interstate commerce. *Id.*

When their customers paid for goods or services with their credit cards, petitioners effectively guaranteed payment to the merchants and thus bore the risk of non-payment by the customers. App. 7a. Petitioners' primary assets consisted of unsecured consumer loans arising from customer use of Capital One credit cards. App. 25a. Petitioners generated interest and other income through finance charges on outstanding loan receivables, fees from credit card transactions, and interest on investments. *Id.*

Petitioners worked with collection agencies and attorneys to collect delinquent customer accounts. App. 7a & n.10. Capital One Services, Inc., an affiliate of petitioners' parent, occasionally engaged attorneys in Massachusetts to bring actions against defaulting customers. App. 29a.

2. The Massachusetts financial institution excise tax (FIET) statute provides: "[E]very financial institution engaged in business in the commonwealth shall pay, on account of each taxable year, an excise measured by its net income determined to be taxable . . . ." MASS. GEN. LAWS ch. 63, § 2 (App. 66a-69a). FIET liability is based on a percentage of a financial institution's net income. *Id.*[1]

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[1] Respondent agreed with petitioners' characterization of the FIET as a "tax" on petitioners' income, even though in Massa-

The FIET applies to any financial institution that "regularly engag[es] in transactions with customers in the commonwealth that involve intangible property and result in income flowing to the taxpayer from residents of the commonwealth," even if the taxpayer has no physical presence in Massachusetts. MASS. GEN. LAWS ch. 63, § 1 (App. 56a). A financial institution is presumed to be taxable if it engages in transactions with 100 residents or has $10 million in assets or $500,000 in receipts attributable to Massachusetts. *Id.*

C. Procedural Background

1. Respondent, the Commissioner of Revenue of Massachusetts, sought to impose the FIET on Capital One Bank for the years 1995 through 1998, and on Capital One F.S.B. for the years 1996 through 1998. App. 1a-2a. After respondent assessed FIET liability of $1,758,454 against Capital One Bank and $159,075.25 against Capital One F.S.B., petitioners applied for abatement, arguing that the Commerce Clause prohibited the assessments. App. 8a-9a. Respondent denied petitioners' applications. App. 9a.

[Footnote continued from previous page]

chusetts there are "historical differences between a tax and an excise." App. 1a-2a n.2. In any event, where, as here, a state tax is measured by a share of a taxpayer's net income, the statutory designation of that tax is irrelevant for purposes of the "substantial nexus" inquiry—regardless of whether the tax is called an excise, franchise tax, business-license tax, gross-receipts tax, value-added tax, or capital-stock tax. *Cf. Hunt-Wesson, Inc.* v. *Franchise Tax Bd. of Cal.*, 528 U.S. 458, 464 (2000) (a "tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes") (internal quotation marks omitted).

2. The Appellate Tax Board upheld respondent's denial of abatement. App. 23a-53a. The Board rejected petitioners' claim that Massachusetts could not, consistent with the Commerce Clause, impose the FIET on petitioners' income because they had no in-state physical presence and therefore lacked a "substantial nexus" with Massachusetts. App. 30a-32a.

3. The SJC affirmed. App. 1a-22a. Petitioners' core argument, the SJC stated, "is that the board erroneously limited to the sales and use tax context the United States Supreme Court's holding in *Quill* . . . that the Federal commerce clause precludes a State from imposing tax obligations on an out-of-State corporation that has no physical presence in the taxing State." App. 11a.

The SJC disagreed, holding instead that *Quill* had a "narrow focus on sales and use taxes for the physical presence requirement," a requirement that "did not apply to the imposition of other types of State taxes." App. 17a. The SJC relied heavily on dicta in *Quill*, in which this Court remarked that "it had not, 'in [its] review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes,'" and that "'concerning other types of taxes, [it had] not adopted a similar bright-line, physical-presence requirement.'" App. 16a-17a (quoting 504 U.S. at 314, 317 (alterations in original)). In addition, the SJC reasoned that for "substantial nexus" purposes, state income taxes on non-domiciliary corporations are constitutionally distinguishable from sales and use taxes because the former are *per se* less burdensome than the latter: "An income-based excise," the SJC opined, "typically is paid only once a year . . . to one taxing jurisdiction at the State level, and the

payment of such an excise does not entail collection obligations vis-à-vis consumers." *Id.* at 20a n.17.

Although it rejected physical presence as a prerequisite, the SJC identified no method for determining what degree of connection short of physical presence counts as a "substantial nexus." Instead, the SJC expressed agreement with another court's conclusion that a mere "significant economic presence" within the state was sufficient to justify income taxation. App. 20a.

The SJC then announced that the "substantial nexus" requirement was satisfied in this case, because petitioners "were providing valuable financial services to Massachusetts consumers" by "using Massachusetts banking and credit facilities"; petitioners "addressed customer complaints with the assistance of the Massachusetts Attorney General's office"; and petitioners "used the Massachusetts court system to recover payment for delinquent accounts." App. 22a. The SJC thus upheld taxation of petitioners' income under the Commerce Clause (*id.*), based in part on the view that the entire "'notion of physical presence'" was "'anachronistic'"—"even more" so "today than it was in 1992," when *Quill* was decided (*id.* at 21a n.18 (quoting 504 U.S. at 327-328 (White, J., dissenting in part)).

REASONS FOR GRANTING THE PETITION

I. THE DECISION BELOW CONFLICTS WITH THIS COURT'S PRECEDENTS

The Supreme Judicial Court's resolution of the important constitutional question presented is irreconcilable with the reasoning employed by this Court in *Quill* and other cases. In particular, the SJC (1) artificially constricted the physical-presence rule

to the sales-and-use-tax context, overlooking *Quill*'s significance as an authoritative construction of *Complete Auto*'s universal "substantial nexus" requirement; (2) improperly ignored the heavy burdens on interstate commerce imposed by state income taxes, in an attempt to justify preferential treatment of such taxes; (3) impermissibly elevated form over substance in treating sales and use taxes as entirely distinct from income taxes for purposes of assessing "substantial nexus"; (4) failed to consider the practical benefits for interstate commerce of adherence to a clear physical-presence standard rather than the SJC's vague economic-nexus approach; and (5) conflated the "substantial nexus" inquiry under the Commerce Clause with the "minimum contacts" inquiry under the Due Process Clause. This Court's review is necessary to address the SJC's profound misinterpretation of the "substantial nexus" prong, and to clarify that *Quill*'s physical-presence requirement extends beyond the narrow corner into which the SJC confined it.

A. *Quill*'s Explication Of "Substantial Nexus" Cannot Be Confined To The Sales-And-Use-Tax Context

Quill held that the physical-presence requirement for state taxation of non-domiciliaries, as articulated in *Bellas Hess*, correctly implements the constitutional mandate that the taxpayer must have a "substantial nexus" with the taxing State. *Quill* did not explicitly resolve the question whether the physical-presence requirement extends to taxes other than sales and use taxes, instead leaving that question for later consideration (504 U.S. at 314, 317), but the Court's reasoning points inexorably to an affirmative answer to that question. *Quill* reaffirmed

that "a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." *Id.* at 311. Indeed, this Court has *never* construed the Constitution to authorize a State to impose *any* tax on an out-of-state entity that neither owns any property within the State nor maintains any representatives (whether employees or independent contractors) within the State.

The logic of *Quill* is clear: The Commerce Clause requires a "substantial nexus" for *all* state taxation, and a "substantial nexus" requires that a nondomiciliary corporation have a physical presence in the State before it may be taxed. Mere contact with residents of the State through the channels of interstate commerce, such as "by mail or common carrier," will not suffice. *Id.* Connections between a taxpayer and a State that are equivalent to those present in *Bellas Hess* or *Quill* do not constitute "substantial nexus," a principle that logically applies with equal force to all state taxation of interstate transactions, whether denominated sales, use, income, or excise taxes. Accordingly, while *Quill* applied Commerce-Clause principles to a use tax, lower courts are not free to confine the physical-presence requirement to that context alone.

Defying those principles, the SJC held that *Bellas Hess* and *Quill* are limited to their facts and that the physical-presence requirement has a "narrow focus on sales and use taxes." App. 17a. No precedent, however, justifies subjecting sales and use taxes to *sui generis* constitutional analysis. Instead, this Court has regularly cited *Bellas Hess* when examining taxes outside the sales-and-use class under *Complete Auto*, indicating that the physical-presence rule applies more broadly. *See Tyler Pipe Indus., Inc.* v.

Wash. State Dep't of Revenue, 483 U.S. 232 (1987) (business and occupation taxes); *Commonwealth Edison Co.* v. *Montana*, 453 U.S. 609 (1981) (severance taxes); *Goldberg* v. *Sweet*, 488 U.S. 252 (1989) (excise taxes). That is, *Bellas Hess* and *Quill* addressed use taxes, but announced a rule applicable to state taxation generally. *See Commonwealth Edison*, 453 U.S. at 626 (citing *Bellas Hess* in severance-tax case to support statement that "the interstate business must have a substantial nexus with the State before *any* tax may be levied on it") (emphasis in original). In that respect, *Bellas Hess* and *Quill* resemble *Complete Auto*, which addressed sales taxes but also established a rule applicable to income taxes. *See, e.g.*, *Barclays Bank PLC* v. *Franchise Tax Bd. of Cal.*, 512 U.S. 298, 310-311 (1994).

This Court itself, even before *Bellas Hess*, applied the physical-presence requirement to taxes analogous to the income tax at issue here. In *Norton Company* v. *Department of Revenue of Illinois*, 340 U.S. 534 (1951), Illinois imposed a gross-receipts tax (a tax on a firm's total revenues) on an out-of-state corporation. This Court explained that "[w]here a corporation chooses to stay at home in all respects except to send abroad advertising or drummers to solicit orders which are sent directly to the home office for acceptance, filling, and delivery back to the buyer, it is obvious that the State of the buyer *has no local grip on the seller*." *Id.* at 537 (emphasis added). Because the corporation had a Chicago branch, however, the Court held that Illinois could tax earnings produced through that branch, but not earnings produced through direct-mail orders to the firm's out-of-state headquarters. *Id.* at 537-539. As in *Bellas Hess* and its progeny, the dispositive question for Commerce-Clause purposes in *Norton* was whether

the taxpayer had a physical presence in the taxing state.[2]

The SJC thus had no principled basis for cabining *Quill* to the sales-and-use context. The logic of *Quill* applies to income taxation as well. This Court's review is required to ensure that state courts give full effect to the necessary implications of the "substantial nexus" principles enunciated in *Quill*.

B. The SJC Contradicted This Court's Assessment Of The Economic Burdens Imposed By Income Taxes

The SJC also disregarded this Court's mandate that proper analysis of a Commerce-Clause challenge to a state tax requires consideration of the true burdens imposed by the tax on firms engaged in interstate commerce. As this Court explained, the purpose of the "substantial nexus" requirement is to "limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce." *Quill*, 504 U.S. at 313.

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2 *Accord Standard Pressed Steel Co.* v. *Wash. Revenue Dep't*, 419 U.S. 560, 562 (1975) (holding that imposition of gross-receipts tax on out-of-state corporation was justified, not by substantial sales in State, but because the corporation had an "employee . . . with a full-time job within the State"); *see also Nat'l Geographic Soc'y* v. *Cal. Bd. of Equalization*, 430 U.S. 551, 557 (1977) ("*Standard Pressed Steel* held that maintenance in the taxing State of a single employee . . . whose primary responsibility was to consult with the Washington-based customer regarding its anticipated needs for the out-of-state supplier's product[] established a sufficient relation to activities within the State producing the gross receipts as to support imposition of the tax.").

The *Quill* Court recognized that when sales and use taxes are concerned, the obligations imposed on out-of-state firms would be "unduly burden[some]" in the absence of a physical-presence rule. *Id.* at 313-316 & n.6. The SJC gave short shrift to those concerns in this case, blithely opining that income taxes impose less substantial burdens on out-of-state corporations than do sales and use taxes. App. 19a-21a & n.17. That conclusion conflicts directly with this Court's precedents, which make clear that state income taxes place a significantly *greater* burden on firms engaged in interstate commerce than do the sales and use taxes at issue in *Quill* and *Bellas Hess*.

In particular, this Court has recognized that the burden on out-of-state firms is greater from income-based taxes than from sales and use taxes because the latter require only that firms *collect* the levies from purchasers, whereas income taxes require businesses to *pay* the tax out of their own earnings and also to comply with far more complicated and detailed administrative and computational rules. *See Nat'l Geographic*, 430 U.S. at 557-558 (concluding that "[t]he case for the validity of" a "use tax" is "stronger" than that for a tax on an out-of-state corporation's revenues, because "[t]he out-of-state seller" bears only "the administrative [burden] of collecting" the use tax); *Norton*, 340 U.S. at 537 (concluding that "a state imposing a sales or use tax can more easily meet this burden" of establishing the requisite nexus "because the impact of those taxes is on the local buyer or user," unlike a gross-receipts tax).

The financial obligation imposed by income taxes is thus far more onerous than that imposed by sales taxes, not only because income taxes fall directly on and must be paid by the out-of-state business out of

its own earnings, but also because income taxation by multiple jurisdictions can lead to double taxation. *See Nat'l Geographic*, 430 U.S. at 557-558 (describing the "risk of double taxation" as one reason why income taxes are more constitutionally problematic than sales taxes).[3] The economic-nexus approach adopted by the court below would greatly exacerbate the risk of double taxation by making it far more likely for businesses—even relatively small businesses doing interstate business—to be subjected to taxation in multiple States.

The *administrative* burdens of complying with numerous and disparate income taxation regimes are also onerous. Each jurisdiction can have its own apportionment formulae, sourcing definitions, income classification, depreciation, disclosure requirements, deductions and various other statutory requirements—and these requirements can vary widely among jurisdictions. For example, the tax at issue in this case requires compliance with pages of statutory apportionment rules alone. *See* Mass. Gen. Laws, ch. 63, § 2 (App. 66a-69a); *see generally* Marjorie Gell, *Broken Silence: Congressional Inaction, Judicial Reaction, and the Need For a Federally Man-*

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[3] Because of differences in state apportionment rules, a taxpayer physically located in one State that becomes subject to another State's taxing power on an "economic nexus" theory may be taxed on income that is already being taxed by its domiciliary State. Indeed, Capital One, N.A., faced that situation here, because the income that Massachusetts seeks to tax was already taxed by Virginia. Although this Court has kept substantial-nexus analysis distinct from fair-apportionment analysis, the enhanced risk of double taxation posed by the "economic nexus" theory confirms the need for a physical-presence requirement in order to avoid unduly burdening interstate commerce.

dated Physical Presence Standard For State Business Activity Taxes, 6 PITT. TAX REV. __, __ (manuscript at 22) (forthcoming Spring 2009) (requiring physical presence is even more appropriate for business-activity taxes than for sales and use taxes "because of the sheer number and complexity of different types of business activity taxes as compared to sales and use taxes"). In addition to States, various municipalities—including localities of very different sizes, ranging from New York City (N.Y.C. ADMIN. CODE § 11-603 (2008)) to Hamilton, Ohio (Ordinance 191.03(b) (2001))—have their own corporate income taxes.

Consequently, the burden of complying with the various requirements of the numerous income-taxing jurisdictions, each with its own unique and often contradictory requirements, can become a crushing one for multi-state corporations or small businesses selling products or services nationwide (for example, through the Internet). *See* Megan A. Stombock, *Economic Nexus and Nonresident Corporate Taxpayers: How Far Will It Go?*, 61 TAX LAW. 1225, 1241 (2008). Indeed, abandoning the physical-presence requirement "would require taxpayers to analyze their activities on a jurisdiction-by-jurisdiction, entity-by-entity, year-by-year, and issue-by-issue basis through extensive record maintenance, timely filings in support of returns, potential simultaneous audits, and negotiations and litigations in multiple jurisdictions." *Id.* Adhering to *Quill* would eliminate the burdens and uncertainty fostered by the SJC's approach.

C. The Decision Below Conflicts With This Court's Rejection Of Formalism In Commerce-Clause Analysis

The upshot of the SJC's artificial constriction of *Quill* is that States, by designating a tax as an income tax rather than a sales and use tax, will be able to evade the Constitution's physical-presence requirement for taxation of out-of-state businesses. Under the SJC's view, the very same activities that are constitutionally insufficient to establish "substantial nexus" for purposes of the sales tax *do* suffice to create such a nexus when the State chooses to impose an income tax instead.

If the SJC's understanding of *Quill* were correct, North Dakota could have responded to invalidation of its use tax on non-domiciliary catalog retailers by simply imposing an excise or other tax on the revenues those same retailers earned on sales to North Dakotans. By simple labeling, the State could freely manipulate application of the physical-presence requirement affirmed in *Quill*.

This Court has refused to give States such an "on-off" switch. "*Complete Auto* emphasized the importance of looking past 'the formal language of the tax statute [to] its practical effect,'" because "differently denominated tax[es] with the same economic effect" must be treated similarly. *Quill*, 504 U.S. at 310 (quoting 430 U.S. at 279) (alteration in original). The decision below thus conflicts with *Quill* and *Complete Auto* by resurrecting a thoughtless formalism that applies one method of constitutional analysis to sales and use taxes, while refusing to apply that same methodology to other taxes, even those (like income taxes) that impose greater burdens on

interstate commerce. This Court's precedents reject that misguided approach.

D. The SJC Disregarded *Quill* By Ignoring The Constitutionally-Significant Benefits Of A Bright-Line Rule

Equally inconsistent with *Quill* is the SJC's disregard for the benefits of a clear and consistent bright-line physical-presence rule. This Court emphasized that a bright-line rule "firmly establishes the boundaries of legitimate state authority to impose" tax obligations, "reduces litigation concerning those taxes," "encourages settled expectations," and "fosters investment by businesses and individuals." *Quill*, 504 U.S. at 315-316. Accordingly, the Court concluded that "the bright-line [physical-presence] rule of *Bellas Hess* furthers the ends of the dormant Commerce Clause" through "the demarcation of a discrete realm of commercial activity that is free from interstate taxation." *Id.* at 314-315.

The Court acknowledged that this rule, "[l]ike other bright-line tests," may "appear[] artificial at its edges," but any "artificiality" is "more than offset by the benefits of a clear rule." *Id.* at 315. Clarity is particularly important in this context because "[the] law in this area is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation.'" *Id.* at 315-316 (quoting *Nw. States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 457-458 (1959)).

Those benefits of the bright-line physical-presence requirement apply *a fortiori* to income

taxes. But the vague economic-nexus approach adopted by the court below flies directly in the face of the *Quill* Court's emphasis on clarity and ease of application. Asserting that the "concept of 'substantial nexus' is more elastic than 'physical presence'" (App. 22a), the SJC announced that petitioners had a substantial nexus with Massachusetts without setting forth *any* standard that would enable out-of-state firms to determine what general conduct suffices to enable the State to tax income. The SJC suggested, for example, that "us[e]" of "Massachusetts banking and credit facilities" in the course of "provid[ing] . . . services" to Massachusetts customers alone might be justification enough (*id.*), which invites a host of questions—and raises the prospect that, for example, the SJC would uphold under the Commerce Clause a tax imposed on a non-domiciliary firm that merely cashed checks drawn on a Massachusetts bank. Thus, the decision below clarifies nothing. Instead it sows confusion about the taxing power and increases the compliance burdens imposed on interstate businesses. *Quill*'s bright-line rule avoids exactly that outcome, and the SJC erred in departing from it.

E. The SJC Contradicted *Quill* By Conflating The Separate Analyses Under The Due Process And Commerce Clauses

The SJC's "elastic" standard conflicts with *Quill* in yet another respect. In concluding that petitioners had a "substantial nexus" sufficient to justify Massachusetts' income taxation, the SJC essentially dismantled the fence erected by this Court to separate the Due Process and Commerce Clause inquiries.

The Court in *Bellas Hess* held that a use tax on firms with no in-state physical presence violated both the Due Process and Commerce Clauses, with-

out drawing a clear distinction between the inquiries under those distinct provisions. 386 U.S. at 756-760. *Quill* reaffirmed *Bellas Hess*'s Commerce Clause holding, but not its Due Process holding. In so doing, this Court explained that "the 'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce." 504 U.S. at 313. In other words, the question under the Commerce Clause is not whether it is "fair" to subject a company to taxation in a particular State, but whether a state tax will place an undue burden on interstate commerce. *Id.*

Although the SJC purported to acknowledge the difference between the Due Process and Commerce Clause analyses, its truncated nexus discussion amounted merely to the "fairness" inquiry, looking exclusively to the benefits that petitioners received from engaging in business transactions with Massachusetts customers and using state-based services. App. 22a. The SJC's reliance, for example, on petitioners' "soliciting and conducting significant credit card business" with Massachusetts residents (*id.*) essentially mimicked the analysis that would have been appropriate under the Due Process Clause to determine whether petitioners could be sued in Massachusetts courts. *See, e.g.*, *Burger King Corp.* v. *Rudzewicz*, 471 U.S. 462, 472 (1985). The SJC thereby collapsed the Due Process and Commerce Clause inquiries in exactly the way *Quill* forbids.

II. THE DECISION BELOW EXACERBATES A GROWING CONFLICT AMONG STATE APPELLATE COURTS OVER APPLICATION OF *QUILL* TO INCOME TAXATION

The decision below expands the preexisting conflict among state appellate courts over the question whether *Quill*'s interpretation of the substantial-nexus prong can be confined to sales and use taxes. That conflict is now both clear and mature. Indeed, it has become more pronounced since this Court last considered the question, and only review by this Court will resolve the conflict.

In holding that *Quill*'s interpretation of "substantial nexus" was dependent on and strictly limited to the particular tax at issue in that case, the court below followed the West Virginia Supreme Court of Appeals, which reached the same conclusion in *Tax Commissioner* v. *MBNA America Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006) ("*MBNA*"), *cert. denied sub nom. FIA Card Servs., N.A.* v. *Tax Comm'r of W. Va.*, 127 S. Ct. 2997 (2007). Volunteering that the physical-presence test reaffirmed by this Court in *Quill* "makes little sense in today's world," the West Virginia court announced that *Quill* "applies only to sales and use taxes" and not to other state taxes. *Id.* at 234. In lieu of the *Quill* test, the court selected an amorphous "economic presence" standard for assessing "substantial nexus." *Id.* The dissent vigorously criticized the majority's "strained and inaccurate reading" of *Quill* and its reliance on "legal commentaries with thinly veiled state-favoring taxing agendas," observing that "[i]t would be a strange constitutional doctrine that would countenance one nexus standard for sales and use taxes under the Commerce Clause, and a more relaxed nexus standard for

corporate net income and other state taxes." *Id.* at 236, 239-240 (Benjamin, J., dissenting).

The Indiana Tax Court also recently and explicitly sided with West Virginia. *See MBNA Am. Bank, N.A.* v. *Ind. Dep't of State Revenue*, 895 N.E.2d 140 (2008). Relying on the West Virginia *MBNA* decision, the Indiana court upheld the challenged tax because it viewed "economic presence" as establishing substantial nexus. *Id.* at 144.[4]

Other state appellate courts have reached the opposite conclusion, recognizing that the *Quill* Court's rationale cannot arbitrarily be limited to the particular tax at issue there because the Court was construing the meaning of the "substantial nexus" requirement, which applies to *all* state taxes. Most saliently, in *J.C. Penney National Bank* v. *Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), the Tennessee Court of Appeals rejected the State's bid to cabin *Quill* to sales and use taxes, seeing "no basis for concluding that the analysis should be different in the present case." *Id.* at 839. As the court observed, none of this Court's precedents has "upheld a state tax where the out-of-state taxpayer had absolutely no physical presence in the taxing state." *Id.* at 842. The court concluded that the taxpayer—like petitioners here, a non-domiciliary credit card issuer with no in-state personnel or property—lacked the substantial nexus required to sustain the franchise and excise taxes imposed. *Id.* The Tennessee Supreme Court denied review, and permitted publication of the Court of Appeals' decision. *J.C. Penney*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000)

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[4] Indiana Tax Court decisions are directly appealable to the Indiana Supreme Court. *See* IND. APP. P. R. 63(A).

(per curiam). That order gave the appellate court's decision binding statewide precedential effect. *See Meadows* v. *State*, 849 S.W.2d 748, 752 (Tenn. 1993) (published opinions of Tennessee Court of Appeals may be relied on with same "confidence and reliability" as those of Tennessee Supreme Court).[5]

The direct conflict between the decision below and *J.C. Penney*—the functional equivalent of a judgment by the highest court of Tennessee—makes this Court's intervention necessary.[6] In addition, however, appellate courts in other States have also rejected the view, adopted below, that *Quill*'s reasoning is limited to the sales-and-use-tax context.

Thus, in *Rylander* v. *Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000), a case involving a state franchise tax, the Texas Court of Appeals explicitly considered and rejected the State's assertion that

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[5] The West Virginia (640 S.E.2d at 235) and Indiana (895 N.E.2d at 143) courts acknowledged, but failed to grapple with, *J.C. Penney*. The SJC erroneously deemed *J.C. Penney* to have been undercut by a later unpublished decision. App. 18a n.16 (citing *Am. Online, Inc.* v. *Johnson*, No. M2001-00927COA-R3-CV, 2002 WL 1751434 at *2 (Tenn. Ct. App. July 30, 2002) ("*AOL*")). But *AOL* held merely that disputed fact issues foreclosed summary judgment, because it was unclear to what extent the taxpayer had personnel or leased components in the State. 2002 WL 1751434 at *1, *3. Moreover, the unpublished *AOL* decision could not have overruled the published *J.C. Penney* decision. *See Allstate Ins. Co.* v. *Watts*, 811 S.W.2d 883, 886 n.2 (Tenn. 1991) (unpublished decisions have only "persuasive force").

[6] This Court has often addressed Commerce-Clause issues in the state taxation context without waiting for the emergence of a split in authority as pronounced and mature as the one here. *See* Cert. Pet. in *Hunt Wesson, Inc.* v. *Franchise Tax Bd. of Cal.*, No. 98-2043, at 15-27 (no conflict asserted); Cert. Pet. in *General Motors Corp.* v. *Tracy*, No. 95-1232, at 14 (same).

"*Quill Corp.* and *Bellas Hess* should be limited to the context of sales and use taxes." *Id.* at 299. The court explained that, "[w]hile the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause." *Id.* at 300. "[W]hen the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state," the court concluded, "no sufficient nexus exists to permit the state to assess tax." *Id.*

Similarly, in *Guardian Industries Corp.* v. *Department of Treasury*, 499 N.W.2d 349 (Mich. Ct. App. 1993), an in-state taxpayer contended that "because it was subject to income taxation for sales in" other, "target" States in which it had solicited business, it was entitled under Michigan law to reduce the amount of its income taxable in Michigan by a corresponding amount. *Id.* at 352-353. The then-applicable statute exempted sales taxable in another State from Michigan tax if "that [other] state has jurisdiction" to impose the tax. *Id.* at 353 (quoting MICH. STAT. ANN. § 7.558(42)). The dispositive question, therefore, was whether income taxation by "target" States would violate the Commerce Clause. *Id.* at 356. The court held that the physical-presence test controlled the answer: "[A]fter *Quill*, it is abundantly clear that Guardian must show a physical presence within a target state to establish a substantial nexus to it." *Id.* Remanding for factual development, the court explained that "[a] target state that taxed Guardian's [sales] solicitation activities would be in violation of the [C]ommerce [C]lause if Guardian's employees were never present within the state." *Id.* at 357.

The decision below therefore is irreconcilable with the reasoning of appellate decisions in Tennessee, Texas, and Michigan, each of which holds that *Quill*'s interpretation of "substantial nexus" cannot be confined to the sales-and-use-tax context. This conflict among state appellate courts is now substantial and mature. Resolution by this Court is necessary.[7]

Because the constitutional question presented arises from state taxation, this Court cannot await a federal circuit conflict before answering it. Taxpayers are barred from raising Commerce-Clause challenges to state taxes in the lower federal courts, because the Tax Injunction Act prohibits those courts from restraining "the assessment, levy or collection of any tax under State law where a plain, speedy and

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[7] A distinct question is whether a State may tax nondomiciliaries (often called intangible holding companies) whose only assets are intellectual property rights that they license to corporations—typically commonly-owned—that use those rights within the State while selling goods or services, and pay royalties to the out-of-state licensor. Some courts addressing intangible holding companies have held that the out-of-state licensor's lack of physical presence does not bar taxation. *See Bridges* v. *Geoffrey, Inc.*, 984 So.2d 115 (La. Ct. App. 2008); *Lanco, Inc.* v. *Dir., Div. of Taxation*, 908 A.2d 176 (N.J. 2006); *A&F Trademark, Inc.* v. *Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004); *Kmart Props., Inc.* v. *Taxation & Revenue Dep't of N.M.*, 131 P.3d 27 (N.M. Ct. App. 2001); *Geoffrey, Inc.* v. *Okla. Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005); *Geoffrey, Inc.* v. *S.C. State Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993). Those cases are not controlling here, as the SJC acknowledged; they "involved foreign corporations with intangible property . . . that was being used in the taxing State by a licensee." App. 21a n.19. By contrast, during the tax years at issue here, petitioners did not earn income through the in-state use of their intellectual or other property by a commonly-controlled affiliate.

efficient remedy may be had in the courts of such State." 28 U.S.C. § 1341. Accordingly, this Court is the *only* federal court that can resolve the growing disagreement and confusion in the state appellate courts regarding the import of this Court's decision in *Quill*.

III. THE QUESTION PRESENTED IS CRITICALLY IMPORTANT TO INTERSTATE COMMERCE AND WARRANTS THIS COURT'S REVIEW AT THIS TIME

As *Bellas Hess* and *Quill* recognized, when a state abandons the physical-presence requirement, it adversely affects interstate commerce by creating confusion and placing onerous burdens on multistate firms. In recent years, those harms have multiplied, as a growing number of States has adopted amorphous and inconsistent economic-nexus tests for income and excise taxes. That trend accelerated after this Court's denial of certiorari in *MBNA*, and is growing increasingly out of control as ever-more States seek to increase their revenues at the expense of out-of-state businesses. Given the current economic crisis and Congress's consistent inaction, only a ruling from this Court can stop the flood of state efforts to impose unduly heavy burdens on interstate commerce.

A. State Abandonment Of The Physical-Presence Requirement Harms The Nation's Economy

The question presented is "one of the most important unanswered questions facing state taxpay-

ers,"[8] because it has major implications for every taxpayer whose business activities cross state lines. At present, the lack of sufficiently clear guidance from this Court regarding the constitutional limits on state income taxation of out-of-state corporations has led to a confusing patchwork of inconsistent state case law, legislation, and administrative determinations adopting widely varying standards for identifying those limits.[9] State approaches range from continued insistence on the physical-presence requirement to various versions of the economic-nexus approach, often with different standards applied to different types of entities.[10]

This wide variation among the States regarding what is fundamentally a question of federal constitutional law creates substantial burdens and uncertainty for businesses faced with deciding whether they are obligated to pay income taxes in multiple States. *See* Stombock, *supra*, at 1231. Particularly

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[8] Marianne Evans & Sarah McGahan, *Economic Nexus and the Uncertainty of* Quill's *Physical-Presence Test*, THE TAX ADVISER (June 2007).

[9] *See* Point II, *supra*; Arthur R. Rosen & Jeffrey S. Reed, *Stop the State Tax Grab*, LEGAL TIMES, April 14, 2008 at 28 (observing that "what constitutes 'substantial nexus' is unclear and has provoked a firestorm of fierce debate"); Gell, *supra*, (manuscript at 22); Joseph Henchman, *Why The* Quill *Physical Presence Rule Shouldn't Go The Way Of Personal Jurisdiction*, 46 STATE TAX NOTES 387 (Nov. 5, 2007); Julie Roman Lackner, Note, *The Evolution and Future of Substantial Nexus in State Taxation of Corporate Income*, 48 B.C. L. REV. 1387, 1408-1415 (2007).

[10] For example, some States have pursued non-domiciliary financial institutions with particular force. *See* Jerome R. Hellerstein & Walter Hellerstein, STATE TAXATION ¶ 6.30 (3d ed. 1998 & Supp. 2009).

problematic in this regard are those States, now including Massachusetts, that have rejected the traditional bright-line physical-presence standard in favor of some version of "economic nexus." That inherently vague approach maximizes discretion in the tax collector, provides little or no guidance to potentially liable multistate businesses, and greatly increases the risk of double taxation. *See* Point I.B., *supra.*

Even when two States both say they apply an "economic nexus" standard, that phrase is so malleable that they may mean very different things. States are thus sowing confusion even as they seriously undermine the Commerce Clause's restraint on state taxation. *See* n.9, *supra*; n.12, *infra*; *see also* Stombock, *supra*, at 1231. This growing uncertainty is exactly the sort of "controversy and confusion" that has previously been of concern to this Court, offering "little in the way of precise guides to the States in the exercise of their" taxation powers. *Quill*, 504 U.S. at 315 (internal quotation marks omitted).

The cost of complying with state income taxes is already double the cost of complying with the federal income tax, and such disproportionate compliance costs will only increase as firms are required to file in more and more jurisdictions under vague "economic nexus" tests. *See* Sanjay Gupta & Lillian Mills, *Does Disconformity in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, 56 NAT'L TAX J. 355, 357 (2003). This increased burden will hit small and medium-sized businesses especially hard, because those firms do not have the resources to comply with numerous different income taxation regimes or contest tax assessments in far-flung jurisdictions. Such businesses may well decide against expanding their operations to other States or the Internet, out of a justified fear that they may be

opening themselves up to onerous tax liabilities and compliance costs.[11]

Moreover, state abandonment of the physical-presence requirement threatens to disrupt this Nation's international tax policy. Pursuant to bilateral tax treaties, the United States has agreed not to impose national income taxes on foreign firms that do not have a "permanent establishment" in the United States, in exchange for reciprocal commitments from our treaty partners. *See* United States Model Income Tax Convention of November 15, 2006, art. 7, ¶ 1; *see also id.* art. 5. As States become more aggressive in enforcing income taxes against foreign-based corporations with no in-state physical-presence, that increasingly burdensome taxation will create tensions with our tax-treaty partners, potentially encouraging them to abandon their physical-presence commitments, thereby undermining the United States' efforts to promote foreign commerce and harming U.S.-based firms. As this Court has warned, "a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential." *Japan*

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[11] Moreover, state abandonment of the physical-presence requirement hampers business compliance with applicable accounting rules. Under Interpretation Number 48 issued by the Financial Accounting Standards Board—which sets standards for preparing audited financial statements in the United States—a corporation must record a liability for the full amount of an unpaid tax liability unless it is "more likely than not" that the corporation will prevail in contesting that liability. Uncertainty over the permissibility and meaning of the vague economic-nexus standard makes compliance with this requirement increasingly difficult and problematic. *See* Michael S. Schadewald, *FIN 48 Forces Companies to Wrestle with Uncertain State Nexus Standards*, THE CPA JOURNAL ONLINE (May 2008).

Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434, 448-449 (1979). The prospect of interference with tax treaties is an especially dangerous one given the pressures toward protectionism and economic balkanization during the current economic crisis. *See* Emma Vandore, *OECD Warns Against Protectionism*, ASSOCIATED PRESS, March 3, 2009.

B. The Problem Has Grown Dramatically Worse Since The Denial Of Certiorari In *MBNA*

The need for this Court's review is more urgent now than it was when this Court denied certiorari in *MBNA* in 2007. Academic commentators and practitioners alike have increasingly recognized the problems created by state adoption of the economic-nexus approach and the growing uncertainty and confusion in this area of the law.[12] In addition, the past two years have seen a headlong rush by revenue-greedy state legislatures and tax collectors to adopt amorphous economic-nexus standards as a means of increasing tax revenues without raising the ire of in-state taxpayers.

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12 *See, e.g.*, Giles Sutton et al., *Attributional Nexus, Flash Title, and the Chaos in Nexus Standards*, 50 STATE TAX NOTES 491 (Nov. 24, 2008); Edward A. Zelinsky, *Rethinking Tax Nexus and Apportionment: Voice, Exit, and the Dormant Commerce Clause*, 28 VA. TAX REV. 1, 15-20 (2008); articles cited *supra* n.9; *see also* David E. Wildasin, *State Corporation Income Taxation: An Economic Perspective on Nexus*, IFIR Working Paper No. 2009-08, at 13 (Feb. 2009) (economic analysis concluding that corporate income taxes imposed on out-of-state corporations based on in-state sales "impose[] an implicit tariff o[n] imports from other states, distorting interstate trade and generating deadweight efficiency losses").

As one major accounting firm recently observed: "The 'rash' of economic nexus decisions and legislation . . . really kicked off with the 2007 cert[iorari] denial[]" in *MBNA* and "spread like poison ivy in 2008." KPMG LLP, *2008: Year in Review: The "Economics" of 2008, in* TWIST-Q: A Quarterly Roundup of This Week in State Tax (Dec. 2008); *see also* Gell, *supra*, (manuscript at 24). Thus, numerous States have adopted economic-nexus approaches in the past two years. *See, e.g.*, Karen J. Boucher & Shona Ponda, *Current Corporate Income Tax Developments (Part I)*, THE TAX ADVISER 166, 166-168 (March 2009). The proliferation of economic-nexus theories since review was denied in *MBNA* has occurred notwithstanding this Court's reminders that denial of certiorari "imports no expression of opinion upon the merits of a case." *House* v. *Mayo*, 324 U.S. 42, 48 (1945). These state actions in disregard of *Quill* indicate that unless this Court intervenes, the burdens inflicted on interstate commerce by amorphous economic nexus standards will only continue to grow.

Just weeks after this Court denied review in *MBNA*, for example, the New Hampshire legislature amended the statutory definition of taxable "business activity" to include "a substantial economic presence evidenced by a *purposeful direction* of business toward the state examined in light of the frequency, quantity, and *systematic* nature of a business organization's economic *contacts* with the state" (emphases added). That amendment took effect July 1, 2007. Ch. 263 (H.B. 2), Laws 2007, amending N.H. REV. STAT. ANN. § 77-A:1, XII; *see* Chris Sullivan, *New Hampshire Adopts Economic Nexus Standard*, 45 STATE TAX NOTES 213 (July 23, 2007) (noting that the legislature "deferred consideration of the

provision while the economic nexus question was pending before the Supreme Court" and then acted promptly upon denial of certiorari).

Similarly, Michigan has embraced "a broadly expanded economic presence nexus standard that will increase the number of businesses subject to . . . tax" in the wake of the denial of review in *MBNA*. June Summers Haas, *The Michigan Business Tax Taxpayer: Jurisdiction to Tax and the Unitary Business Group*, 53 WAYNE L. REV. 1351, 1351 (2007). In particular, under the Michigan Business Tax (MBT), enacted in July 2007 (just weeks after the denial of certiorari) and effective January 1, 2008, a person is considered to have a nexus with Michigan sufficient to require payment of the MBT if the person "actively solicits" sales within the State, and has in-state gross receipts of or exceeding a specified dollar threshold. MICH. COMP. LAWS § 208.1200(1). Michigan has opined that "[w]hether substantial economic presence is established depends on the quality and quantity of the taxpayer's contacts with the taxing state and the degree to which the taxpayer exploits the market." Mich. Revenue Admin. Bulletin 2007-6, at 4 (Dec. 28, 2007). That highly malleable formulation "is more of a Due Process nexus standard" than a test under the Commerce Clause. Haas, *supra*, at 1359.[13]

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13 California made a similar change recently in enacting its 2009-10 budget. Effective January 1, 2011, the State amended the statutory definition of "doing business" for tax purposes to cover any taxpayers whose in-state sales exceed the lesser of $500,000 or 25% of total sales. Senate Bill No. X3 15, § 7 (amending CAL. REV. & TAX. CODE § 23101(b)(2)) (enrolled Feb. 19, 2009); *see* Deloitte Development LLC, *California Budget Legislation Contains Significant Tax Law Changes* 4 (Feb. 27, 2009) ("The adoption of a doing business standard that relies

Other States likewise have seized upon denial of review in *MBNA* as an occasion for issuing regulatory guidance asserting authority to tax non-domiciliary corporations with no in-state physical presence. Florida, for example, found *MBNA* "persuasive, especially given the fact that the U.S. Supreme Court declined to hear the case[]." Fla. Dep't of Revenue, Advisement 07C1-007, 2007 WL 4577924, at *6 (Oct. 17, 2007); *see also* Me. Revenue Servs., Maine Tax Alert (Feb. 2008), 2008 WL 2764732, at **2-3 (noting denial of review in *MBNA*, and stating that Maine "considers taxpayers with economic nexus alone to be subject to Maine's income tax laws"); Or. Dep't of Revenue Substantial Nexus Guidelines, OR. ADMIN. R. 150-713.010 (rev. May 2008) ("[s]ubstantial nexus" "does not require a taxpayer to have a physical presence in Oregon" and "exists where a taxpayer regularly takes advantage of Oregon's economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state.").

C. Awaiting Congressional Action Would Be Futile

Review by this Court should not be further delayed based on a speculative hope that Congress might at some point decide to address the problem posed by the economic-nexus theory. Questions about the scope of state taxing powers under the Commerce Clause are ones "that Congress has the ultimate power to resolve" (*Quill*, 504 U.S. at 318),

[Footnote continued from previous page]

solely on having sales in California would appear to effectively adopt an 'economic nexus' standard for California.").

but Congress has shown no inclination to address the issue. Accordingly, this Court has both the authority and the responsibility to ensure compliance with its precedents, and it is not for the States to legislate away the bright-line physical-presence requirement. Rather, if States conclude that the physical-presence requirement should be abandoned (or limited only to certain taxes), they are free to present that argument to Congress through the ordinary political process.

In *MBNA*, the State argued that the Court should deny review in order to give Congress a chance to act. *See* Br. in Opp., No. 06-1228, at 17-18. But Congress still has not acted in the two years since denial of review in *MBNA*, while the States have increasingly violated the principles enunciated in *Quill*, exacerbating the problems created by the economic-nexus approach. In fact, in the 17 years since *Quill* invited congressional resolution of the scope of state taxing power over non-domiciliaries, Congress has not addressed the issue, indicating that there is no realistic prospect that Congress will do so in the foreseeable future.[14] This Court should take this opportunity to ensure that States, in their insatiable demand for more sources of revenue (particularly from politically disenfranchised out-of-state businesses), do not continue to defy the principles enunciated in *Quill* and *Bellas Hess*.

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[14] For example, although business-activity-tax simplification bills have been introduced in recent Congresses, no votes have ever been cast on the portions of such legislation addressing the scope of the physical-presence requirement. Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. (2009); Business Activity Tax Simplification Act of 2007, S. 1726, 110th Cong. (2007); Internet Tax Fairness Act of 2001, H.R. 2526, 107th Cong. (2001); New Economy Tax Fairness Act, S. 664, 107th Cong. (2001).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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March 19, 2009

APPENDIX

APPENDIX A

Supreme Judicial Court of Massachusetts,
Suffolk.

CAPITAL ONE BANK & another[1]

v.

COMMISSIONER OF REVENUE.

Argued Oct. 7, 2008.

Decided Jan. 8, 2009.

Present: MARSHALL, C.J., IRELAND, SPINA, COWIN, CORDY, & BOTSFORD, JJ.

SPINA, J.

The present appeal is from a decision of the Appellate Tax Board (board) affirming the denial by the Commissioner of Revenue (commissioner) of applications by the taxpayers, Capital One Bank (Capital One) and Capital One F.S.B. (FSB) (collectively, Capital banks), for the abatement of financial institution excises (FIET).[2] Capital One sought abate-

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1 Capital One F.S.B.

2 The Appellate Tax Board (board) noted that G.L. c. 63, § 2, imposes an excise, not a tax, on financial institutions. For an extensive discussion of the historical differences between a tax and an excise, *see* P. Nichols, Taxation in Massachusetts 15-17

[Footnote continued on next page]

ment for the tax years 1995 through 1998, and FSB sought abatement for the tax years 1996 through 1998. At issue is whether, consistent with the Federal commerce clause of the United States Constitution art. 1, § 8, the Commonwealth can impose the FIET, pursuant to G.L. c. 63, § 2, on financial institutions[3] that do not have a physical presence in Massachusetts. We granted the Capital banks' application for direct appellate review, and now affirm the board's decision.[4]

The board found the following facts, based on the parties' detailed stipulation of facts and the testimony and exhibits introduced at the hearing. *See* G.L. c. 58A, § 13 ("The decision of the board shall be final as to findings of fact"); *United Church of Religious Science v. Assessors of Attleboro*, 372 Mass. 280, 281, 361 N.E.2d 1254 (1977).

In 1994, Capital One was established as a wholly owned subsidiary of Capital One Financial Corpora-

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[Footnote continued from previous page]
(3d ed. 938). Here, for consistency and ease of reference, we, like the parties and the board, shall refer to the excise at issue as the financial institution excise tax (FIET).

3 A "[f]inancial institution" includes "any bank, banking association, trust company, federal or state savings and loan association, including all banks for cooperatives organized under the United States Farm Credit Act of 1933, whether of issue or not, existing by authority of the United States, or any state, or a foreign country, or any law of the commonwealth." G.L. c. 63, § 1.

4 We acknowledge the amicus brief filed by Multistate Tax Commission in support of the board, and the amicus brief filed by the Council on State Taxation in support of Capital One Bank and Capital One F.S.B.

tion (COFC), a Delaware corporation. Capital One is a Virginia-chartered credit card bank that offers credit card products. FSB was established in 1996, also as a wholly owned subsidiary of COFC. It is a federally chartered savings bank that offers consumer lending and deposit products, including secured and unsecured credit cards, to individuals and small businesses. FSB also makes unsecured installment loans and has a consumer home loan business.

The commercial domicil for each bank is Virginia, where credit approval activities occurred. During the tax years at issue, the Capital banks neither owned nor leased any real property in the Commonwealth. Further, the board assumed, based on the record before it, that the Capital banks owned no other Massachusetts property,[5] and no employee, agent, or independent contractor of the Capital banks was located in Massachusetts during the tax years at issue. As credit card issuers doing business in the Commonwealth, the Capital banks had been required to file quarterly credit card issuer's reports

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[5] The board noted that it was unclear whether credit card readers used by merchants were the property of the Capital banks, the merchants, or some other entity. Further, the record was not clear as to whether the cardholders, the Capital banks, or both had ownership of the credit cards themselves. The board stated that because its decision was not dependent on the Capital banks' ownership of property or other physical presence in Massachusetts, the ownership of the credit cards and the card readers was immaterial.

with the Massachusetts division of banks. *See* G.L. c. 140, § 114C, inserted by St.1987, c. 595, § 1.[6]

COFC is the owner of the trademark "Capital One," which it provided to the Capital banks, without license or royalty, for placement on their credit cards. Using a system called "Information-Based Strategy," which employs statistical modeling techniques to segment potential customer lists based on credit scores, demographics, and other characteristics, the Capital banks targeted specific potential customers nationwide, including customers in the Commonwealth. As pertinent here, the Capital banks then entered into agreements with Massachusetts residents for the issuance of "general purpose" credit cards branded with the "Capital One" trademark and the logo of either Visa U.S.A. Inc. (Visa), or MasterCard International (MasterCard).[7] Pursuant

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6 In 1996, the filing requirement for a credit card issuer's reports was changed from quarterly to semiannually. *See* St. 1996, c. 359, § 2. Subsequent legislation deleted this filing requirement from G.L. c. 140, § 114C, altogether. *See* St. 2002, c. 455, § 1.

7 Visa and MasterCard are structured as open associations whose members issue Visa-branded or MasterCard-branded payment cards, acquire merchants that will accept such payment cards, or do both. Visa and MasterCard provide services for their members, including the authorization, settlement, and clearance of transactions. With certain limited exceptions, Visa's membership is open to any institution that is eligible for Federal Deposit Insurance Corporation deposit insurance or share insurance. As of 2005, Visa had approximately 14,000 members in the United States, including over 12,000 Visa card issuers (and had similar membership numbers during the tax years at issue). MasterCard's membership is generally open to any organization that is authorized to engage in financial

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to these agreements, the Capital banks would advance funds on behalf of their customers for transactions in which the customers used a "Capital One" Visa-branded or MasterCard-branded credit card to make purchases of goods and services from merchants nationwide. The Capital banks also would allow customers to obtain cash advances at Capital banks nationwide displaying the Visa or MasterCard logo, or at bank automated teller machine (ATM) kiosks displaying the Visa or MasterCard logo, or at ATM kiosks displaying the PLUS or CIRRUS logo, if such logo also appeared on the credit card.[8] The Capital banks' customers agreed to repay the advanced funds, subject to finance charges and other fees set forth in their credit card agreements.

As members of the Visa and MasterCard associations, the Capital banks paid fees to those associations relating to credit card transactions nationwide, including transactions by the Capital banks' Massachusetts customers. In return, the Capital banks received numerous benefits from the Visa and MasterCard associations, including technology and equipment necessary to process credit card transactions. On a larger scale, the Capital banks were able to access a nationwide interconnected credit infrastruc-

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transactions under the laws or government regulations of the country in which it is organized or principally engaged in business, subject to additional requirements set out in MasterCard bylaws and rules.

8 The PLUS name is a trademark owned by Visa International Service Association and licensed to Visa. The CIRRUS name is a trademark owned by MasterCard.

ture that provided enormous value both to their own businesses and to the Capital banks' customers.

A typical credit card transaction proceeded as follows. When a Massachusetts customer presented a "Capital One" Visa-branded or MasterCard-branded credit card in payment for goods or services, the cardholder or merchant would "swipe" the card through a card reader located at the merchant's place of business. The credit card information would be relayed to an "acquiring bank" with which the merchant had contracted for the handling of credit card transactions. The acquiring bank verified, processed, and transmitted the credit card information to Visa or MasterCard, which, in turn, relayed the transaction information to the cardholder's "issuing bank" (here, the Capital banks), which then checked the cardholder's credit line and account status. Assuming that the cardholder had sufficient credit, the issuing bank approved the transaction, and such approval was sent by the issuing bank through the association network to the acquiring bank, which relayed the approval to the merchant at the point of sale. This process occurred in one rapid series of events. Subsequently, payment requests were sent by the merchant to the acquiring bank, which forwarded them to the issuing bank for reimbursement. The issuing bank paid the acquiring bank the amount requested, less an "interchange fee." The acquiring bank then retained its own processing fee from the amount received, and paid the remainder to the merchant.[9] During the tax years at

[9] To put these fees in perspective, the board noted that in a typical Visa or MasterCard transaction, the issuing bank re-

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issue, the Capital banks received interchange fees related to Massachusetts customers ranging between $4.2 million and $6.8 million annually.

By issuing credit cards with the "Capital One" logo to Massachusetts customers, the Capital banks essentially were guaranteeing payment to merchants of the amounts charged by those customers, if approved. The Capital banks bore the risk of a cardholder's nonpayment. In the event of such nonpayment, the Capital banks worked with collection agencies[10] and Massachusetts attorneys to collect delinquent accounts, which included the filing of civil actions on behalf of the Capital banks in Massachusetts courts. When necessary, the Capital banks obtained garnishments or liens against their customers' personal property, and, on two occasions, secured writs of execution against Massachusetts real property. If legal proceedings were commenced in Virginia against Massachusetts residents under the Virginia long-arm statute, Va. Code Ann. § 8.01-328.1 (2007), the resulting judgments were, at times, domesticated to Massachusetts for further enforcement proceedings. In addition, the Massachusetts Attorney General's office, through its consumer com-

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tained an "interchange fee" of approximately 1.4 per cent of the transaction price, and the acquiring bank retained an additional fee of approximately .6 per cent. Consequently, a total of approximately 2.0 per cent of the transaction amount, known as the "merchant discount," would be paid to the issuing and acquiring banks. *See United States v. Visa U.S.A., Inc.*, 344 F.3d 229, 235 (2d Cir. 2003).

[10] None of the collection agencies used during the tax years at issue was located in Massachusetts.

plaints and information section, helped resolve disputes between the Capital banks and Massachusetts residents during the tax years at issue.

As a result of the Capital banks' marketing efforts in the Commonwealth, the number of Massachusetts residents carrying Capital One credit cards rose from 196,645 in 1995 to 465,571 in 1998, and the number of Massachusetts residents carrying FSB credit cards rose from 3,845 in 1996 to 7,363 in 1998. In total, the Capital banks spent more than $20 million, through its marketing efforts, to acquire Commonwealth residents as customers during the tax years at issue. Capital One's outstanding receivables from accounts held by Massachusetts cardholders grew from $72,162,796 in 1995 to $113,655,624 in 1998. FSB's outstanding receivables from accounts held by Massachusetts cardholders grew from $11,457,826 in 1996 to $16,588,914 in 1998. Capital One's income, derived from interest, fees, and penalties associated with the use of its credit cards by Massachusetts residents, rose from $22,319,653 in 1995 to $57,941,377 in 1998. FSB's income, derived from the same sources, rose from $1,534,525 in 1996 to $3,483,093 in 1998.

On February 28, 2000, in response to notification from the commissioner that they had not filed FIET returns for the tax years at issue, the Capital banks provided the Department of Revenue (department) with apportionment and other relevant information. On August 6, 2000, the department issued to the Capital banks separate notices of intention to assess, followed shortly thereafter by notices of assessment for the tax years at issue. The amounts of the assessments were $1,758,454 for Capital One, and $159,075.25 for FSB. The Capital banks filed timely applications for abatement of the FIET. *See* G.L. c.

62C, § 37. The commissioner denied the applications, and the Capital banks appealed to the board pursuant to G.L. c. 62C, § 39.

In affirming the commissioner's denial of the abatements, the board stated that the Capital banks' activities in Massachusetts constituted a "substantial nexus" with the Commonwealth that justified imposition of the FIET for the tax years at issue. In particular, the board based its determination on the Capital banks' purposeful, targeted marketing of their credit card business to Massachusetts customers; their required filing of quarterly credit card issuer's reports with the Massachusetts division of banks; their use of the Massachusetts court system and the Massachusetts Attorney General's office to collect delinquent accounts and resolve disputes; their use of sophisticated networks, including the Visa and MasterCard associations and Massachusetts acquiring banks, which linked the Capital banks with Massachusetts customers and merchants, and by which the Capital banks, through their customers' use of "Capital One" branded credit cards, guaranteed payment to the merchants on behalf of the customers; and their receipt of hundreds of millions of dollars in income from millions of transactions involving Massachusetts residents and merchants.[11] The board stated that, pursuant to its

[11] The Capital banks contend that the record does not show that they actually filed any credit card issuer's reports with the Massachusetts division of banks or initiated contact with the Attorney General's office. The Capital banks may not, in fact, have filed any reports pursuant to G.L. c. 140 § 114C, but the statutory language suggests that they were required to do so. In addition, even if the Capital banks did not initiate any con-

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reading of *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S. Ct. 1904, 119 L.Ed.2d 91 (1992) (*Quill*), a financial institution's "physical presence" in the taxing State was not required to establish "substantial nexus" for purposes of the State's imposition of an income-based tax on that institution. Consequently, the board concluded that the Commonwealth's assessment of the FIET on the Capital banks was constitutional under the Federal commerce clause.[12]

A decision by the board will not be modified or reversed if the decision "is based on both substantial evidence and a correct application of the law." *Boston Professional Hockey Ass'n v. Commissioner of Revenue*, 443 Mass. 276, 285, 820 N.E.2d 792 (2005). We presume that a tax is constitutionally valid unless the party challenging it establishes its invalidity "beyond a rational doubt." *Andover Sav. Bank v. Commissioner of Revenue*, 387 Mass. 229, 235, 439 N.E.2d 282 (1982). While we give deference to the board's expertise in interpreting the tax laws of the Commonwealth, *see French v. Assessors of Boston*, 383 Mass. 481, 482, 419 N.E.2d 1372 (1981), we ap-

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tact with the Attorney General's office, Massachusetts consumers filed complaints against them with that office, and the Capital banks responded to those complaints.

12 The board also concluded that the privileges associated with the Capital banks' right to do business in Massachusetts and the Capital banks' sale of financial services in the Commonwealth were "commodities," and that the FIET was a "reasonable" excise on such commodities under the Massachusetts Constitution. *See* Part 2, c. 1, § 1, art. 4, of the Constitution of the Commonwealth. The Capital banks have not challenged this determination in the present appeal, so we need not consider it further.

ply our independent judgment as to both the law and the facts on constitutional issues. *See Opinion of the Justices*, 328 Mass. 679, 687, 106 N.E.2d 259 (1952).

The thrust of the Capital banks' appeal is that the board erroneously limited to the sales and use tax context the United States Supreme Court's holding in *Quill, supra* at 317-318, 112 S. Ct. 1904, that the Federal commerce clause precludes a State from imposing tax obligations on an out-of-State corporation that has no physical presence in the taxing State. In the Capital banks' view, this physical presence requirement should be equally applicable to a State's assessment of an income-based excise, like the FIET. The Capital banks contend that the board disregarded the reasons stated in *Quill* for upholding a "bright-line" test for tax liability and the benefits of such a clear standard. Contrary to the board's determination, the Capital banks continue, sales and use taxes do not impose a more significant burden on interstate commerce than income-based taxes such that the two types of taxes should be treated differently under the commerce clause. For these reasons, the Capital banks argue that the FIET should be deemed unconstitutional as inconsistent with the Federal commerce clause. We disagree.

Pursuant to G.L. c. 63, § 2, "every financial institution engaged in business in the commonwealth shall pay, on account of each taxable year, an excise measured by its net income determined to be taxable under [G.L. c. 63, § 2A,] at the [designated] rate."[13]

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[13] General Laws c. 63, § 2A (*b*), provides that "[i]f the financial institution has income from business activity which is taxable both within and without this commonwealth, its net in-

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The Capital banks have not asserted that they are not "financial institutions" for purposes of imposition of the FIET. *See* G.L. c. 63, § 1 (defining "[f]inancial institution"). As pertinent to the factual circumstances here, the phrase "engaged in business in the commonwealth" includes "regularly engaging in transactions with customers in the commonwealth that involve intangible property and result in income flowing to the taxpayer from residents of the commonwealth." *Id.* These activities "shall be presumed, subject to rebuttal, to be conducted on a regular basis within the commonwealth, if any of such activities are conducted with one hundred or more residents of the commonwealth during any taxable year or if the taxpayer has ten million dollars or more of assets attributable to sources within the commonwealth, or has in excess of five hundred thousand dollars in receipts attributable to sources within the commonwealth." *Id.* The Capital banks have challenged the imposition of the FIET only on constitutional grounds; they have not rebutted the statutory presumption that they have regularly engaged in business in Massachusetts.

A State's ability to tax businesses like the Capital banks, that operate in interstate commerce, "is constrained by the Federal government's broad power to regulate interstate commerce under the commerce clause."[14] *Aloha Freightways, Inc. v.*

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come shall be apportioned to this commonwealth by multiplying its net income by the apportionment percentage."

14 Because the Capital banks have challenged the constitutionality of the FIET under only the commerce clause, that is the focus of our consideration. Nonetheless, we point out that a

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Commissioner of Revenue, 428 Mass. 418, 421, 701

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State's ability to tax businesses operating in interstate commerce also is constrained by the due process clause of the Fourteenth Amendment to the United States Constitution. Although unconstitutional taxation claims under the due process and commerce clauses are closely related, *see National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 756, 87 S. Ct. 1389, 18 L.Ed.2d 505 (1967), they are separate and "pose distinct limits on the taxing powers of the States." *Quill Corp. v. North Dakota*, 504 U.S. 298, 305, 112 S. Ct. 1904, 119 L.Ed.2d 91 (1992) (*Quill*). The due process clause and the commerce clause address different constitutional concerns. Due process focuses on "the fundamental fairness of governmental activity" and requires consideration "whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him." *Id.* at 312, 112 S. Ct. 1904. Thus, the due process clause requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. v. Maryland*, 347 U.S. 340, 344-345, 74 S. Ct. 535, 98 L.Ed. 744 (1954). *See International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435, 441-442, 64 S. Ct. 1060, 88 L.Ed. 1373 (1944) ("A state may tax such part of the income of a nonresident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers"). *See also Truck Renting & Leasing Ass'n v. Commissioner of Revenue*, 433 Mass. 733, 736, 746 N.E.2d 143 (2001). "In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy." *Quill, supra.* Consistent with the due process clause, a State may have the authority to impose a tax based on minimum contacts, but the imposition of such a tax may unconstitutionally burden interstate commerce because the taxpayer lacks a "substantial nexus" with the taxing State. *See id.* at 308, 313, 112 S. Ct. 1904.

N.E.2d 961 (1998). The commerce clause authorizes Congress to "regulate Commerce . . . among the several States." Art. 1, § 8. The United States Supreme Court has consistently held that the commerce clause includes "a further, negative command, known as the dormant Commerce Clause, prohibiting certain state taxation even when Congress has failed to legislate on the subject." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179, 115 S. Ct. 1331, 131 L.Ed.2d 261 (1995). *See Quill, supra* at 309-312, 112 S. Ct. 1904 (discussing evolution of dormant commerce clause).

Consistent with the commerce clause, a State may impose a tax on a business engaged in interstate commerce where the tax "[1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S. Ct. 1076, 51 L.Ed.2d 326 (1977) (*Complete Auto*). *See Truck Renting & Leasing Ass'n v. Commissioner of Revenue*, 433 Mass. 733, 740, 746 N.E.2d 143 (2001). By permitting States to tax purely interstate commerce, the United States Supreme Court affirmed the principle that "interstate commerce may be made to pay its way." *Complete Auto, supra* at 281, 284, 97 S. Ct. 1076. *See Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623624, 101 S. Ct. 2946, 69 L.Ed.2d 884 (1981), quoting *Colonial Pipeline Co. v. Traigle*, 421 U.S. 100, 108, 95 S. Ct. 1538, 44 L.Ed.2d 1 (1975) ("It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of [the] state tax burden even though it increases the cost of doing business").

The Capital banks' challenge to the constitutionality of the FIET focuses solely on the first prong of the *Complete Auto* test, namely whether the Capital banks' activities had a "substantial nexus" with Massachusetts.[15] To satisfy this requirement, "[t]he business must have some constitutionally sufficient degree of contact with the taxing State before the State can impose any tax on it." *Aloha Freightways, Inc. v. Commissioner of Revenue, supra.* It is a standard that is designed to prevent overreaching by States. *Id.* at 423, 701 N.E.2d 961. "[T]he 'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce." *Quill, supra* at 313, 112 S. Ct. 1904.

The roots of a "physical presence" requirement under commerce clause analysis were firmly established in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 87 S. Ct. 1389, 18 L.Ed.2d 505 (1967) (*Bellas Hess*), which involved a constitutional challenge to a State's assessment of a use tax on goods purchased for use in the taxing State from an out-of-State mail order merchant that had no in-State retail outlets, sales representatives, or property. The United States Supreme Court concluded that a State's assessment of a use tax in such circumstances created an unconstitutional burden on interstate commerce because the merchant's only

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15 Because the Capital banks' challenge to the constitutionality of the FIET under the commerce clause pertains only to the first prong of the *Complete Auto* test, we limit our discussion to that requirement.

connections with the taxing State were by mail or common carrier. *Id.* at 758-759, 87 S. Ct. 1389. The Court's reasoning for its decision was based, in significant part, on the fact that the many local variations in rates of use tax, in allowable exemptions, and in administrative requirements would impede the free conduct of interstate business. *Id.* at 759-760, 87 S. Ct. 1389. The very purpose of the commerce clause, the Court stated, "was to ensure a national economy free from such unjustifiable local entanglements." *Id.* at 760, 87 S. Ct. 1389.

Twenty-five years later, the United States Supreme Court reaffirmed in *Quill, supra* at 317-318, 112 S. Ct. 1904, that, with respect to the imposition of sales and use taxes, the constitutionally sustainable measure of contact required for substantial nexus under the commerce clause was "physical presence" in the taxing State. The Court made a point of stating that "[w]hile contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today," *id.* at 311, 87 S. Ct. 1389, the *Bellas Hess* bright-line physical presence requirement was not inconsistent with the four-part *Complete Auto* test, which the Court described as "continu[ing] to govern the validity of state taxes under the Commerce Clause." *Quill, supra* at 310, 112 S. Ct. 1904. Nothing, however, in *Quill* suggested that physical presence is required for the imposition of other types of taxes, including an income-based excise such as the FIET. To the contrary, while not repudiating the *Bellas Hess* rule, the Supreme Court stated in Quill that it had not, "in [its] review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes." *Id.* at 314, 112 S. Ct. 1904 (stating that

Court's commerce clause jurisprudence "now favors more flexible balancing analyses"). Moreover, when summarizing the precedent established in *Bellas Hess*, the Court reiterated that, in cases "subsequent to *Bellas Hess* and concerning other types of taxes, [it had] not adopted a similar bright-line, physical-presence requirement." *Id.* at 317, 87 S. Ct. 1389. *See Truck Renting & Leasing Ass'n v. Commissioner of Revenue*, *supra* at 740 n. 13, 746 N.E.2d 143 (noting that, in *Quill*, Supreme Court did not extend physical presence requirement for imposition of use or sales tax on out-of-State vendor to other types of taxes). *Cf. Borden Chems. & Plastics v. Zehnder*, 312 Ill.App.3d 35, 44, 244 Ill.Dec. 477, 726 N.E.2d 73 (2000) (declining to extend *Quill*'s physical presence requirement to income-based taxation, but recognizing that such requirement would have been satisfied by taxpayer at issue); *Couchot v. State Lottery Comm'n*, 74 Ohio St.3d 417, 425, 659 N.E.2d 1225, *cert. denied*, 519 U.S. 810, 117 S. Ct. 55, 136 L.Ed.2d 18 (1996) (same).

The language of the Supreme Court's decision in *Quill* explicitly emphasized, on more than one occasion, a narrow focus on sales and use taxes for the physical presence requirement, and suggested that this requirement was limited to those specific assessments and did not apply to the imposition of other types of State taxes. We will not expand the Court's reasoning beyond its articulated boundaries, particularly where the Court, itself, has limited its holding to a particular form of taxation.

In a case similar to the present one, the West Virginia Supreme Court of Appeals considered in *Tax Comm'r of W. Va. v. MBNA Am. Bank, N.A.*, 220 W.Va. 163, 164-166, 640 S.E.2d 226 (2006), *cert. denied sub nom. FIA Card Services, N.A. v. Tax*

Comm'r of W. Va., ___ U.S. ___, 127 S. Ct. 2997, 168 L.Ed.2d 719 (2007) (*MBNA*), whether imposition of that State's business franchise and corporation net income taxes on MBNA America Bank, a Delaware corporation with no physical presence in West Virginia, violated the substantial nexus requirement of the commerce clause. The principal business of MBNA America Bank was issuing and servicing Visa and MasterCard credit cards, which it promoted in West Virginia by mail and telephone solicitation. *Id.* at 164, 640 S.E.2d 226. After considering the evolution of the Supreme Court's interpretation of the dormant commerce clause, the court in *MBNA* concluded that "*Quill's* physical-presence requirement for showing a substantial Commerce Clause nexus applie[d] only to use and sales taxes and not to business franchise and corporation net income taxes." *Id.* at 169, 640 S.E.2d 226.[16]

In reaching its conclusion, the West Virginia Supreme Court of Appeals opined that (1) the United States Supreme Court's decision in *Quill* was based

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16 Contrast *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 842 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927, 121 S. Ct. 305, 148 L.Ed.2d 245 (2000) (stating that, while it was not court's purpose "to decide whether 'physical presence' is required under the Commerce Clause," lack of substantial nexus did not justify assessment of franchise and excise taxes on out-of-State credit card company), questioned in *America Online, Inc. v. Johnson*, No. M2001-00927COA-R3-CV, 2002 WL 1751434 (Tenn. Ct. App. July 30, 2002) (noting that in *J.C. Penney Nat'l Bank v. Johnson*, *supra*, it might have been more accurate for court to say that "the Supreme Court had rejected state taxes on interstate commerce where no activities had been carried on in the taxing state *on the taxpayer's behalf*" [emphasis in original]).

primarily on *stare decisis* and on the fact that the precedent established in *Bellas Hess* had engendered substantial reliance by the mail order industry, circumstances that did not compel application beyond the context of sales and use taxes; (2) the Supreme Court appeared to have expressly limited the scope of *Quill* to sales and use taxes; and (3) the Supreme Court's decisions in *Bellas Hess* and *Quill* were based, in part, on the fact that compliance with specific administrative regulations associated with the collection of sales and use taxes unduly burdened interstate commerce, but that the collection of franchise and income taxes did not appear to cause similar compliance burdens.[17] *Id.* at 169-170, 640 S.E.2d

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[17] Contrary to the Capital banks' assertion, the board's finding that sales and use taxes impose special burdens on interstate commerce was not based on faulty logic. In its discussion of these burdens with respect to an out-of-State mail order company, the United States Supreme Court observed in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 759, 87 S. Ct. 1389, 18 L.Ed.2d 505 (1967), that if one State can impede "the free conduct of [such company's] interstate business," then "so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes." As a result, the Court stated, "[t]he many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [the mail order company] in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.'" *Id.* at 759-760, 87 S. Ct. 1389, quoting *Freeman v. Hewit*, 329 U.S. 249, 253, 67 S. Ct. 274, 91 L.Ed. 265 (1946). Similarly, in *Quill*, *supra* at 313 n. 6, 112 S. Ct. 1904, the Supreme Court noted that upholding one State's imposition of a use tax on an out-of-State mail order company could unduly burden interstate com-

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226. The court further stated that the physical presence test "makes little sense in today's world" where, for example, "electronic commerce now makes it possible for an entity to have a significant economic presence in a state absent any physical presence there."[18] *Id.* at 171, 640 S.E.2d 226. The analysis set forth in *MBNA* is persuasive.[19]

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merce where "similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions." Such burdens associated with the imposition of sales and use taxes are not inconsequential. An income-based excise, on the other hand, typically is paid only once a year (except when quarterly estimated taxes are required), to one taxing jurisdiction at the State level, and the payment of such an excise does not entail collection obligations vis-à-vis consumers. *See Tax Comm'r of W. Va. v. MBNA Am. Bank, N.A.*, 220 W.Va. 163, 170-171, 640 S.E.2d 226 (2006), *cert. denied sub nom. FIA Card Servs., N.A. v. Tax Comm'r of W. Va.*, ___ U.S. ___, 127 S. Ct. 2997, 168 L.Ed.2d 719 (2007). Determinations about whether the Capital banks are subject to the FIET, in the first instance, and how to apportion income from business activity that is taxable within the Commonwealth are the sorts of decisions that, more broadly, can confront all taxpayers, local or out-of-State, when calculating, reporting, and paying taxes on their income. While the making of these determinations is certainly more complex for large corporate taxpayers, it is part of the cost of doing business and is not, in our opinion, unduly burdensome on interstate commerce, particularly where such taxpayers, like the Capital banks, are earning substantial income from their business activities in Massachusetts and where the common usage of computer technology and specialized software has eased the administrative burdens of tax compliance.

18 In a separate opinion in *Quill*, Justice White stated: "Perhaps long ago a seller's 'physical presence' was a sufficient part of a trade to condition imposition of a tax on such presence. But in today's economy, physical presence frequently has very little

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Like the West Virginia court, we conclude that the constitutionality, under the commerce clause, of the Commonwealth's imposition of the FIET is de-

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to do with a transaction a State might seek to tax. Wire transfers of money involving billions of dollars occur every day; purchasers place orders with sellers by fax, phone, and computer linkup; sellers ship goods by air, road, and sea through sundry delivery services without leaving their place of business.... [A]n out-of-state direct marketer derives numerous commercial benefits from the State in which it does business [and the Court should not, under the commerce clause,] attempt to justify an anachronistic notion of physical presence in economic terms." *Quill*, *supra* at 327-328, 112 S. Ct. 1904 (White, J., concurring in part and dissenting in part). This observation is even more true today than it was in 1992.

19 In its determination, the board cited several post-*Quill* decisions that upheld the imposition of income-based taxes on out-of-State corporations that had no tangible physical presence in the taxing State. *See, e.g.*, *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 S.C. 15, 23-24 & n. 4, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992, 114 S. Ct. 550, 126 L.Ed.2d 451 (1993) (stating that *Quill* did not extend physical presence requirement beyond sales and use taxes, and concluding that licensing intangible property for use in taxing State established substantial nexus for imposition of income-based tax). *See also Lanco, Inc. v. Director, Div. of Taxation*, 188 N.J. 380, 383, 908 A.2d 176 (2006) (*per curiam*), *cert. denied*, ___ U.S. ___, 127 S. Ct. 2974, 168 L.Ed.2d 702 (2007); *Kmart Props., Inc. v. Taxation & Revenue Dep't*, 139 N.M. 177, 185-186, 131 P.3d 27 (Ct. App. 2001), *rev'd on other grounds*, 139 N.M. 172, 131 P.3d 22 (2005); *A & F Trademark, Inc. v. Tolson*, 167 N.C.App. 150, 159-163, 605 S.E.2d 187 (2004), *cert. denied*, 546 U.S. 821, 126 S. Ct. 353, 163 L.Ed.2d 62 (2005). While these cases are instructive with respect to their analysis of *Quill*, they are not directly on point factually, because all involved foreign corporations with intangible property (trademarks, trade names, and service marks) that was being used in the taxing State by a licensee.

termined not by *Quill*'s physical presence test, but by the "substantial nexus" test articulated in *Complete Auto*. Accordingly, we turn to the facts of the present case to determine whether Capital One and FSB had a substantial nexus with this Commonwealth during the tax years at issue.

While the concept of "substantial nexus" is more elastic than "physical presence," it plainly means a greater presence, both qualitatively and quantitatively, than the minimum connection between a State and a taxpayer that would satisfy a due process inquiry. *See* note 14, *supra*. Simply put, the test is "substantial" nexus, not "minimal" nexus. In addition to their consumer lending activities, the Capital banks were soliciting and conducting significant credit card business in the Commonwealth with hundreds of thousands of Massachusetts residents, generating millions of dollars in income for the Capital banks. In essence, the Capital banks were providing valuable financial services to Massachusetts consumers, for which the Capital banks were compensated in the form of interest payments, interchange fees, and finance charges. They could not provide such services in the Commonwealth without using Massachusetts banking and credit facilities. In addition, the Capital banks addressed customer complaints with the assistance of the Massachusetts Attorney General's office, and, when necessary, they used the Massachusetts court system to recover payment for delinquent accounts. Based on the findings of the board, we conclude that the Capital banks' activities in Massachusetts established a substantial nexus with the Commonwealth and, therefore, the assessment of the FIET on the Capital banks comported with the Federal commerce clause.

Decision of the Appellate Tax Board affirmed.

APPENDIX B

Appellate Tax Board
Commonwealth of Massachusetts

CAPITAL ONE BANK AND CAPITAL ONE F.S.B.

v.

COMMISSIONER OF REVENUE

Docket Nos. C262391 & C262598

June 22, 2007

FINDINGS OF FACT AND REPORT

In these appeals, the appellants, Capital One Bank ("COB") and Capital One F.S.B. ("FSB" and, together with COB, the "Banks"), challenge the constitutionality of the financial institution excise ("FIET")[1] and the determination of the appellee Commissioner of Revenue ("Commissioner") that the Banks' in-state activities constituted substantial

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[1] Both parties adopted the acronym "FIET" for the excise at issue, based on their description of the excise as the "financial institution excise tax." The Board notes that G.L. c. 63, 2 imposes an excise, not a tax, on financial institutions. *See* P. NICHOLS, TAXATION IN MASSACHUSETTS 16 (3rd ed. 1938). For consistency and ease of reference, however, the Board also refers to the excise as the "FIET."

nexus with the Commonwealth of Massachusetts justifying the imposition of the FIET on them.

On the basis of the parties' detailed Stipulation of Facts, exhibits and the testimony introduced at the hearing of these appeals, the Appellate Tax Board ("Board") made the following findings of fact.

I. JURISDICTION

In response to a notification from the Commissioner that they had not filed FIET returns for the years at issue, the Banks provided the Commissioner with apportionment and other relevant information on or about February 28, 2000. The Commissioner issued separate Notices of Intention to Assess to COB and FSB on August 6, 2000. The Commissioner then issued Notices of Assessment dated September 6, 2000 and September 12, 2000, to COB and FSB, respectively. The amounts of the assessments at issue in these appeals are $1,758,454.96 for COB and $159,075 for FSB.

The Banks timely filed applications for abatement of the FIET with the Commissioner on July 10, 2001, which he denied on July 20, 2001. The Banks then timely filed their appeals with the Board on September 17, 2001. On the basis of the foregoing, the Board found and ruled that it had jurisdiction to hear and decide these appeals.

II. THE BANKS' MASSACHUSETTS BUSINESS

At all material times,[2] COB was a Virginia chartered credit card bank offering credit card products.

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2 Unless explicitly stated otherwise, all factual findings relate to the years at issue.

It was established in 1994 as a wholly-owned subsidiary of Capital One Financial Corporation ("COFC"), which is a Delaware corporation. COB's commercial domicile was in Virginia, where credit approval activity took place.

FSB was a federally chartered savings bank that offered consumer lending and deposit products, including secured and unsecured credit cards, to individuals and small businesses. FSB also made unsecured installment loans and had a consumer home loan business. It was established in 1996 as a wholly-owned subsidiary of COFC.

COFC was the owner of the trademark "Capital One" and provided the trademark to the Banks, without license or royalty, to appear on credit cards which the Banks issued to customers in Massachusetts.

As credit card companies doing business in Massachusetts, the Banks were required to file quarterly credit card issuer's reports with the Massachusetts Division of Banks.

During the years at issue, the Banks' primary assets consisted of consumer loans using Capital One credit cards as the credit extension vehicle. The Banks also issued certificates of deposit and accepted secured credit card savings deposits. Both COB and FSB generated interest and other income through finance charges assessed on outstanding loan receivables, fees from credit card transactions described below, and interest earned on investment securities and money market investments.

Using a system called Information-Based Strategy ("IBS"), which used statistical modeling techniques that segment potential customer lists based on credit scores, demographics, and other character-

istics, the Banks targeted specific potential consumers in Massachusetts. As a result of the Banks' marketing efforts in Massachusetts, the number of Massachusetts residents carrying COB credit cards rose from slightly fewer than 200,000 to more than 460,000 during the years at issue and FSB's Massachusetts customers rose from less than 4,000 to more than 7,000 during that period. The Banks acknowledged spending between $50 and $100 per individual cardholder on marketing; at more than 400,000 cardholders in Massachusetts, the Banks spent an estimated $20 million-plus to acquire Massachusetts residents as customers during the periods at issue.

The acquisition of Massachusetts customers has resulted in millions of dollars in income to the Banks; COB's receivables related to Massachusetts customers grew from $72,162,796 to $113,655,624 during the years at issue, while FSB's receivables from Massachusetts accounts grew from $11,457,826 to $16,588,914. COB's income from Massachusetts customers rose from $22,319,653 in 1995 to $57,941,377 in 1998, while FSB's Massachusetts income rose from $1,534,525 in 1996 to more than $3,000,000 in both 1997 and 1998.

The Banks entered into agreements with Massachusetts residents for purposes of issuing "general purpose" credit cards branded with the Capital One trademark and the logo of either Visa or MasterCard. Visa and MasterCard are associations whose members issued credit cards with the association's logo, acquired merchants that accepted the association's credit cards, or both. Visa and MasterCard provided services for their members, including the authorization, settlement and clearance of transactions.

Under the credit card agreement, the Banks agreed to advance funds on behalf of their customers for transactions in which the customer used the "Capital One" Visa-branded credit card or the "Capital One" MasterCard-branded credit card to make purchases of goods and/or services from merchants or other service providers nationwide. The Banks also agreed to allow customers to obtain cash advances at banks nationwide displaying the Visa or MasterCard logo or at bank automated teller machines ("ATMs") displaying the Visa or MasterCard logo, or at ATMs displaying the PLUS or CIRRUS logo, if the logo also appeared on the card.[3]

The Banks were members of the Visa and MasterCard associations and paid them fees relating to credit card transactions nationwide, including those relating to credit card transactions engaged in by the Banks' Massachusetts customers. As members of the Visa and MasterCard associations, the Banks received numerous benefits, including technology and equipment necessary to process credit transactions. As members, the Banks were able to tap into a nationwide interconnected infrastructure that provided enormous value to their business and their customers, who received a credit card that could be used virtually anywhere, including within the Commonwealth.

A typical credit card transaction proceeds as follows. When a customer presents a credit card in payment for goods or services, the cardholder or mer-

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3 The PLUS name is a trademark owned by Visa International Service Association and licensed to Visa. The CIRRUS name is a trademark owned by MasterCard.

chant typically "swipes" the card through a card-reader located at the merchant's place of business. The credit card information is relayed to an "acquiring bank" with which the merchant has contracted. The acquiring bank processes, packages and transmits that information to the Visa, MasterCard or other association network. The association network then relays the transaction information to the cardholder's "issuing bank," in this case, the Banks. The issuing bank approves the transaction assuming the cardholder has a sufficient credit line and the approval is sent by the issuing bank via the network to the acquiring bank, which relays the approval to the merchant. Payment requests are sent by the merchant to the acquiring bank, which forwards the request to the issuing bank. The issuing bank then pays the acquiring bank the amount requested, less what is called an "interchange fee." The acquiring bank then retains its own fee from the amount received, and pays the remainder to the merchant.[4] During the years at issue, the Banks received interchange fees related to Massachusetts customers ranging between $4.2 million and $6.8 million annually.

As issuing banks, the Banks bore the risk of the cardholder's non-payment. The Banks billed their customers, including Massachusetts customers, di-

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[4] In a typical Visa or MasterCard transaction, the acquiring bank retains 1.4 percent of the purchase price as an interchange fee and the issuing bank 0.6 percent as its fee; accordingly, a total of 2.0 percent of the merchant's sale price, known as the "merchant discount," is paid to the issuing and acquiring banks. *See United States of America v. Visa, U.S.A.*, 344 F.3d 229, 235 (2d Cir. 2003).

rectly and the cardholders had a number of days to pay the statement in full. Interest was charged on unpaid balances at a rate set by the Banks in their contracts with customers. By issuing credit cards with the "Capital One" logo to Massachusetts customers, the Banks were essentially guaranteeing payment to merchants of the amounts charged by the Banks' customers.

In the event of non-payment by its customers, the Banks worked with collection agencies and attorney networks to collect delinquent accounts. These agencies and attorneys provided collection services to the Banks related to their Massachusetts customers, and instituted legal proceedings on behalf of the Banks in Massachusetts courts. Capital One Services, Inc. ("COSI"),[5] a subsidiary of COFC that provided advertising, marketing, administrative and management services to the Banks, engaged Massachusetts attorneys to bring actions against customers in default on behalf of the Banks.

In furtherance of the Banks' collection efforts in Massachusetts, the Banks obtained garnishments or liens against personal property and secured writs of execution against Massachusetts real estate. If court actions were brought in Virginia against Massachusetts residents under the Virginia long-arm statute, those judgments were at times domesticated to Mas-

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[5] Another COFC subsidiary, Oakstone Ventures, Inc, was created to identify non-bank business opportunities because the Banks were prohibited from engaging in such activities. Beginning in 1998, Oakstone had an office in Boston, Massachusetts and an Oakstone employee participated in discussions with the Banks concerning strategies for the provision of financial services, including credit card strategies, in Massachusetts.

sachusetts for further enforcement proceedings. The Massachusetts Attorney General's Office also helped mediate disputes between the Banks and Massachusetts residents during the years at issue, offering assistance through its Consumer Complaints and Information Section and nineteen Local Consumer Programs located throughout Massachusetts.

The Banks neither owned nor leased real property in Massachusetts. Further, the Board assumes on this record that the Banks owned no other Massachusetts property[6] and no Bank employee, agent or independent contractor[7] was located in Massachusetts during the years at issue.

The Board found and ruled that the Banks' activities constituted "substantial nexus" with Massachusetts so as to justify imposition of the FIET, irrespective of whether the Banks had a physical presence in Massachusetts during the years at issue. The Banks' purposeful, targeted marketing of their

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[6] It is unclear on the present record whether the card readers used at the merchant locations were the property of the Banks, the merchant, or some other entity. Further, the record is not clear as to whether the card holders or the Banks or both had an ownership in the credit cards themselves. Because the Board's ruling in these appeals is not dependant on the Bank's ownership of property or other physical presence in the Commonwealth, the ownership of the card reader and cards is immaterial.

[7] The Banks argue that the collection activities of their independent contractors dis not establish physical presence because they are *de minimis* and they did not "expand the market" for the Banks' business. Again, because the Board's ruling of substantial nexus is not dependant on physical presence, resolution of this issue is not necessary.

credit card business to Massachusetts customers, their required quarterly filing of Credit Card Issuer's Reports with the Massachusetts Division of Banks, their use of Massachusetts court system and the Massachusetts Attorney General's Office to collect delinquent accounts and resolve disputes with Massachusetts customers, their use of a sophisticated network, including Visa and MasterCard as well as Massachusetts acquiring banks, which linked them with Massachusetts customers and merchants and by which they, through the customers' use of "Capital One"-branded cards, guaranteed payment to the merchant on behalf of the customer, and their deriving of hundreds of millions of dollars in income from millions of transactions involving Massachusetts residents and merchants constituted substantial nexus with Massachusetts.

The Board further found and ruled that the privileges related to the Banks' right to do business and its sale of financial services in the Commonwealth is a "commodity" and the FIET is a "reasonable excise" upon that commodity for purposes ofthe Massachusetts Constitution.

Accordingly, for all of the foregoing reasons, the Board issued decisions for the appellee in these appeals.

OPINION

These appeals raise the issue of whether, as a matter of law, the Commerce Clause of the United States Constitution (U.S. CONST. art. I, § 8, cl. 3, hereafter "Commerce Clause") requires that a corporation must have a "physical presence" in a state before that state may impose an excise measured by the corporation's net income. The Banks also argue that the FIET is an unreasonable, and therefore in-

valid, excise under MASSACHUSETTS CONST. Pt. II, C. 1, § 1, Art. 4.

The Board's authority to rule on constitutional claims in determining the legality of tax assessments is clear. *See, e.g. WB&T Mortgage Company Inc. v. Assessors of Boston*, ATB Findings of Fact and Report 2006-379; *Mullins v. Commissioner of Revenue*, ATB Findings of Fact and Reports 1997-973, *aff'd*, 428 Mass. 406 (1998); *Gillette Co. v. Commissioner of Revenue*, ATB Findings of Fact and Reports 1996-362, *aff'd*, 425 Mass. 670 (1997); *Lonstein v. Commissioner of Revenue*, ATB Findings of Fact and Reports 1988-355, *aff'd*, 406 Mass. 92 (1989); *Tregor v. Assessors of Boston*, ATB Findings of Fact and Reports 1978-203, *aff'd*, 377 Mass. 602 (1979).

In fact, a taxpayer must raise a constitutional claim with the Board to preserve the right to appellate consideration of the issue. *New Bedford Gas & Electric Light Co. v. Assessors of Dartmouth*, 368 Mass. 745, 752 (1975) ("To raise a constitutional question on appeal to this court from the board, the taxpayer must present the question to the board and, in so doing, make a proper record on appeal. Otherwise, the taxpayer waives the right to press the constitutional argument."). Accordingly, the Board has jurisdiction to determine whether the FIET assessed to the Banks is unconstitutional.

In determining whether the FIET is constitutional, the Board's analysis must be guided by the principle that "[a] tax measure is presumed valid and is entitled to the benefit of any constitutional doubt, and the burden of proving its invalidity falls on those who challenge the measure." *Opinion of the Justices*, 425 Mass. 1201, 1203-1204 (1997) (quoting *Daley v. State Tax Commission*, 376 Mass. 861, 865-66

(1978)); *see also Andover Savings Bank v. Commissioner of Revenue*, 387 Mass. 229, 235 (1982). Accordingly, the following analysis proceeds from the presumption that the FIET is valid and that any doubts concerning its interpretation must be resolved in favor of an interpretation that renders it constitutional.

The Board's analysis begins with a review of the FIET statute, followed by a discussion of relevant federal, Massachusetts and other state cases concerning the taxation of interstate commerce under the Commerce Clause, and concludes with a review of the Massachusetts constitutional requirements concerning reasonable excises.

I. MASSACHUSETTS TAXATION OF FINANCIAL INSTITUTIONS

Under G.L. c. 63, § 2, "every financial institution engaged in business in the commonwealth shall pay, on account of each taxable year, an excise measured by its net income determined to be taxable under section two A at the [designated rate]." The Banks do not challenge that they are financial institutions for purposes of § 2 and the remainder of the FIET.

For purposes of the FIET, "engaged in business" is defined in G.L. c. 63, § 1 as:

> (a) having a business location in the commonwealth; (b) having employees, representatives or independent contractors conducting business activities on its behalf in the commonwealth; (c) maintaining, renting or owning any tangible or real property in the commonwealth; ***(e) regularly engaging in transactions with the customers in the commonwealth that involve intangible property and result in income flowing to***

the taxpayer from residents of the commonwealth; (f) regularly receiving interest income from loans secured by tangible personal or real property located in the commonwealth; or (g) regularly soliciting and receiving deposits from customers in the commonwealth. ***With respect to the activities described in clauses (d) to(g), inclusive, activities shall be presumed, subject to rebuttal, to be conducted on a regular basis within the commonwealth, if any of such activities are conducted with one hundred or more residents of the commonwealth during any taxable year or if the taxpayer has ten million dollars or more of assets attributable to sources within the commonwealth, or has in excess of five hundred thousand dollars in receipts attributable to sources within the commonwealth.***

The Commissioner relies upon the highlighted subdivision (e), *i.e.* the Banks were regularly engaged in transactions with Massachusetts customers that involve intangible property and resulted in income flowing to the taxpayer from Massachusetts residents and the highlighted presumption that a financial institution that engaged in transactions with one hundred or more Massachusetts residents, had $10 million or more of assets attributable to Massachusetts sources, or had receipts exceeding $500,000 attributable to Massachusetts sources, for his determination that the Banks were "engaged in business" in, and had nexus with, Massachusetts.

The Banks do not contest that they fall within the explicit terms of the FIET. Rather, they maintain that the Commerce Clause requires their physi-

cal, as opposed to economic, presence in the Commonwealth in order to be subject to a tax measured by their net income.

II. CONSTITUTIONALITY OF FIET UNDER THE COMMERCE CLAUSE

Constitutional limitations on a state's power to tax interstate commerce stem from both the Due Process Clause (U.S. CONST. amend. XIV, § 1, hereafter the "Due Process Clause") and the Commerce Clause. Each clause "reflect[s] different constitutional concerns. Moreover, while Congress has plenary power to regulate commerce among the States and thus may authorize actions that burden interstate commerce... it does not similarly have the power to authorize violations of the Due Process Clause." *Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992).

In the context of taxation, "to survive due process scrutiny, there must be 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'" *Truck Renting and Leasing Ass'n v. Commissioner of Revenue*, 433 Mass. 733, 736 (2001) (quoting *Horst v. Commissioner of Revenue*, 389 Mass. 117, 182 (1983)). Additionally, the "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'" *Id.* (quoting *Quill*, 504 U.S. at 306). At the center of Due Process jurisprudence lies a concern for the "fundamental fairness of government activity." *Quill*, 504 U.S. at 312.

The Banks have not challenged the FIET as violative of the Due Process Clause, nor could they realistically have mounted such a challenge because Massachusetts "has provided the source [for the in-

come at issue] by providing and maintaining the economic setting out of which [the Banks reap their] profit." *Truck Renting*, 433 Mass. at 739 (quoting *American Refrigerator Transit Co. v. State Tax Comm'n*, 395 P.2d 127, 131 (Or. 1964).

Unlike the Due Process Clause, the Commerce Clause is "informed 'by structural concerns about the effects of state regulation on the national economy' and, specifically, any burden on interstate commerce caused by a State tax obligation" rather than fairness for the individual entity that is taxed. *Truck Renting*, 433 Mass. at 740 (quoting *Quill*, 504 U.S. at 312). Accordingly, the Commerce Clause's "substantial nexus requirement is not, like due process' minimum contacts requirement, a proxy for notice but rather a means for limiting state burdens on interstate commerce." *Quill*, 504 U.S. at 313.

A state may, consistent with the Commerce Clause, impose a tax on a company engaged in purely interstate commerce provided that the tax: "[1] is applied to an activity with a substantial nexus with the taxing state, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, [4] and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). In permitting states to tax purely interstate commerce, *Complete Auto* overruled the *Spector Motor Services, Inc. v. O'Connor*, 340 U.S. 602 (1951) and *Freeman v. Hewitt*, 329 U.S. 249 (1946), line of cases, thus reaffirming the principle that "interstate commerce may be made to pay its way." *Complete Auto*, 430 U.S. at 284, 289 n.15. Massachusetts has consistently applied the Complete Auto test. *See Aloha Freightways, Inc. v. Commissioner of Revenue*, 428 Mass. 418, 421 (1998); *Truck Renting*, 433 Mass. at 740.

The Banks' principal challenge to the constitutionality of the FIET is the first or "substantial nexus" prong of *Complete Auto*.[8] "The 'substantial nexus' requirement 'seeks to prevent overreaching by States, and limits a State's ability to tax businesses operating within interstate commerce which lack a sufficient connection to the taxing state.'" *Truck Renting*, 433 Mass. at 740 (quoting *Aloha Freightways*, 428 Mass. at 423). To satisfy the "substantial nexus" requirement, the "business must have some constitutionally significant degree of contact with the taxing State before the State can impose any tax on it." *Aloha Freightways*, 428 Mass. at 421.

In *Quill*, the Supreme Court revisited the issue of substantial nexus in the context of a mail-order company's duty to collect use tax. *Quill*, 504 U.S. at 301. The taxpayer in *Quill* was an out-of-state mail order house "'whose only connection with customers in the State [was] by common carrier or the United States mail.'" *Id.* (quoting *National Bellas Hess* 386 U.S. 753, 758 (1967)). The Supreme Court of North Dakota had declined to follow *National Bellas Hess*, a case with similar facts and issues as in *Quill*, finding the holding "obsolete" under evolving Supreme Court Due Process and Commerce Clause jurisprudence. *Quill*, 504 U.S. at 310-12. Though the Court agreed "with much of the state court's reasoning" (*Id.* at 302) and acknowledged that Due Process Clause concerns were satisfied (*Id.* at 308), it reversed the

[8] The Banks raise only the "substantial nexus" prong in their Petitions to this Board. Although the Banks' brief makes oblique reference to the remaining prongs, the Banks offered no evidence or cogent argument that the FIET fails under prongs two through four of Complete Auto.

state court, reaffirming *National Bellas Hess* and finding insufficient nexus due to the taxpayer's lack of physical presence in the state. *Id.* at 318-19.

In preserving the *National Bellas Hess* bright-line physical presence test as to the duty to collect sales and use taxes, the Court in *Quill* observed that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today" and invited Congress to "decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect taxes." *Id.* at 311 and 318. While it followed *National Bellas Hess* on principles of *stare decisis*, noting in particular that the *National Bellas Hess* physical presence rule "has engendered substantial reliance and has become part of the basic framework of a sizeable industry" (*Quill* 504 U.S. at 317)[9], the Court made clear in two separate instances that it has not extended the "bright-line" physical presence test to taxes other than sales and use tax. *See Quill* 504 U.S. at 314 ("we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes") and *Id.* at 317 ("although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical presence re-

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[9] The Court went on to note that "a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investments by businesses and individuals. [footnote omitted]. Indeed, it is not unlikely that the mail-order industry's dramatic growth over the last quarter century is due in part to the bright-line exemption from state taxation created in Bellas Hess." *Quill*, 504 U.S. at 316.

quirement"). Further, the Court noted that "our Commerce Clause jurisprudence now favors more flexible balancing analyses."

In addition to the settled expectation of the mail order industry and principles of *stare decisis*, the Court in *Quill* also focused on the particular commercial burdens that result from the application of a state's sales and use tax collection duty and recognized the inherent burden a taxpayer could face "if similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions" to collect a use tax. *Id.* at 313 n.6. There are, however, significant distinctions between the burdens resulting from collecting and remitting sales and use taxes and the payment obligation of an income-based tax. As one state court has observed:

> It is also evident from *Quill* that a sales and use tax can impose a special burden on interstate commerce beyond just the payment of money. Unlike an income tax, a sales and use tax can make the taxpayer an agent of the state, obligated to collect the tax from the consumer at the point of sale and then pay it over to the taxing entity. Whereas, a state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates. *See Id.* at 313 n.6. Thus, collecting and paying a sales and use tax can impose additional burdens on commerce that the Supreme Court has repeatedly identified in prior opinions.

Kmart Properties, Inc. v. Taxation and Revenue Dep't, 139 N.M. 177, 185 (2001). *See also Tax Com-*

missioner of the State of West Virginia v. MBNA America Bank, N.A., 640 S.E. 2d 226, 233 (2006) (recognizing that the compliance burdens of sales and use tax collection and remission, including knowledge of a multitude of administrative regulations, extensive record-keeping, and frequent remission to the government, are greater than those of income-based taxes). Further, a commentator has noted that:

> Sales and use taxes and income taxes are functionally different and ultimately have different effects on taxed entities. Simply put, income taxes carry fewer administrative burdens for the taxpayer and pose less of a threat to interstate commerce. Unlike a sales or use tax, which is paid by every consumer, creative tax planners can exempt entire industries from income taxation. Accordingly, it is illogical for a court to apply the same analysis to the constitutionality of income taxes as it does to sales and use taxes."

Cory D. Olson, *Follow the Giraffe's Lead - Lanco, Inc. v. Director, Division of Taxation Gets Lost In The Quagmire That Is State Taxation*, 6 MINN J.L. SCI. & TECH. 789 (2005).

Accordingly, while *Quill* reaffirmed that physical presence is required in the context of a mail-order seller's sales and use tax obligation, there is neither a Supreme Court nor Massachusetts precedent that supports the proposition that physical presence is required to impose an income-based tax such as the FIET. In fact, Massachusetts has recognized the Supreme Court's careful limitation of *Quill* to the sales and use tax context: "[i]n *Quill*. . . the Court upheld a 'physical-presence requirement' before a State, con-

sistent with the commerce clause, could subject an out-of-State vendor to a use or sales tax. *The Court did not extend this rule to other types of tax.*" *Truck Renting*, 433 Mass. 733, 741 n.13 (2001) (emphasis added). *See also Aloha Freightways*, 428 Mass. at 423 n.4 ("Under Aloha's argument, the only State an interstate carrier could be found to have 'nexus' with would be one in which it maintains a base of operations. The requirement of 'nexus' does not provide such tax immunity to interstate carriers.").

With the physical-presence test of *Quill* properly limited to the sales and use tax context, the controlling authority in the instant appeals is *Complete Auto* and its query of whether the FIET is "applied to an activity with a substantial nexus with" Massachusetts. *Aloha Freightways*, 428 Mass. at 421 (quoting *Complete Auto*, 430 U.S. at 279). "Substantial nexus" comprises contacts of varied character and not merely those of a physical nature. For example, in a case virtually identical to the present appeals involving the taxation under a similar bank excise statute of an out-of-state credit card company with no physical presence in the taxing state, the Supreme Court of Appeals of West Virginia held that "[r]ather than a physical presence standard, this Court believes that a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes." *MBNA America Bank*, 640 S.E.2d at 234.

The court in *MBNA America Bank* found that the taxpayer "continuously and systematically engaged in direct mail and telephone solicitation and promotion" in the taxing state and derived "significant gross receipts" from customers located in the state. *Id.* at 235-36. In light of these facts, the court, despite finding that the taxpayer had no real or tangi-

ble personal property or real estate located in the state, had "no trouble concluding that MBNA's systematic and continuous business activity in this State produced significant gross receipts attributable to its West Virginia customers which indicate a significant economic presence sufficient to meet the substantial nexus prong of *Complete Auto*." *Id.* at 236.

In the only other case involving the taxation of an out-of-state credit card company without physical presence cited by the parties, the Tennessee Court of Appeals appears to hold fast to the *Quill* physical-presence test, but a later case by that same court suggests otherwise. In *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), the court ruled that Tennessee could not tax an out-of-state bank offering, among other services, credit-card lending and ATM services, because the bank "did not have a physical presence in Tennessee through its affiliates." *Id.* at 841.

However, several years later, the same Tennessee court seemed to retreat from a bright-line physical presence requirement for substantial nexus or to at least clarify its ruling in *J.C. Penney*. In *America Online, Inc. v. Johnson*, 2002 Tenn. App. LEXIS 555 (2002), the court, addressing whether an internet service provider with no property or employees in Tennessee could be subject to an income-based tax, stated that

> [t]his case is all about the nexus prong of the test. The chancellor held that the Supreme Court's decisions in this area, as interpreted by this court in *J.C. Penney* [citations omitted], has held fast to a bright-line test requiring an out-of-state company to have a 'physi-

> cal presence' in this state in order to have a substantial nexus with it. ***We think, however, that that reading of J.C. Penney would simply substitute "physical presence" for "nexus"*** [footnote omitted] ***as the first prong of the Complete Auto Transit test. As we read the cases, neither [the U.S. Supreme Court nor the Tennessee Court of Appeals] has made that suggestion...***
>
> We do not think that it is conclusive that AOL does not have offices or employees in the state or that it does not own or rent real property here. . . . ***Where. . .activities are "being conducted in the taxing state that substantially contribute to the taxpayer's ability to maintain operations in the taxing state," a substantial nexus does exist.***

America Online 2002 Tenn. App. LEXIS at *2, *3 (quoting *J.C. Penney*, 19 S.W. 3d at 841) (emphasis added).

Other state courts have also upheld the imposition of an income-based tax on out-of-state corporations with no in-state real or tangible personal property or employees. A year after the *Quill* decision, South Carolina became the first state to uphold an income-based tax solely on the presence of trademark assets within the taxing jurisdiction. *See Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993). The out-of-state taxpayer in *Geoffrey* held several valuable trademarks that it licensed to its parent for use in retail stores, including stores in the South Carolina, for a royalty fee of one percent of net sales. *Id.* at 15. The court held that "by licensing intangibles for use in this State and de-

riving income from their use here, Geoffrey ha[d] a 'substantial nexus' with South Carolina." *Id.* at 18. *See also Secretary, Department of Revenue v. Gap (Apparel), Inc.*, 886 S.2d 459, 462 (La. Ct. App. 2004) ("While Apparel may not have a physical presence in Louisiana, its intangible property clearly has a connection with Louisiana.... it is clear that the marks licensed by Apparel have been used in Louisiana in such a way as to become an integral part of the licensees' business in this state.").

In another case involving the imposition of an income-based tax on an out-of-state trademark holding company with no in-state tangible property or representatives, the New Mexico Court of Appeals held that *Quill* does not extend the physical presence requirement to income taxes, ruling that:

> The Commerce Clause analysis of New Mexico income tax is controlled, not by *Quill's* physical presence, but by the overarching substantial nexus test announced in *Complete Auto Transit*. . . .[T]he use of [the taxpayer's] marks within New Mexico's economic market, for the purpose of generating substantial income for the [the taxpayer], establishes a sufficient nexus between that income and the legitimate interests of the state and justifies the imposition of a state income tax.

Kmart, 139 N.M at 186.

North Carolina, in a case involving nine trademark holding companies, also adopted the reasoning of *Geoffrey*, finding that "under facts such as these where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a sub-

stantial nexus with the State sufficient to satisfy the Commerce clause." *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004).

The *A&F Trademark* decision was cited approvingly in a recent New Jersey court decision that upheld an income-based tax on a foreign trademark holding company with "no physical presence in the state and deriv[ing] income from a New Jersey source pursuant only to a license agreement with another corporation that conducts a retail business" in the state. *See Lanco, Inc. v. Director, Division of Taxation*, 879 A.2d 1234, 1235 (N.J. Super. Ct. App. Div. 2005). The court held that "[w]e are satisfied that the physical presence requirement applicable to use and sales taxes is not applicable to income tax and that the New Jersey Business Corporation Tax may be constitutionally applied to income derived [ ] from licensing fees attributable to New Jersey." *Id.* at 1242. Quoting from the *A&F Trademark* opinion, the court declined to extend *Quill* beyond the sales and use tax context:

> The North Carolina Court of Appeals stated three reasons for declining to adopt the broader reading of *Quill* as requiring a physical presence for income tax purposes. . . . "First, the tone in the *Quill* opinion hardly indicates a sweeping endorsement of the bright-line test it preserved, and the Supreme Court's hesitancy to embrace the test certainly counsels against expansion of it.". . . The [United States Supreme] Court further observed the physical-presence test, though offset by the clarity of the rule, was "artificial at its edges.". . . In addition the Court twice noted that in other types of taxes, it had never articulated the same

> physical-presence requirement adopted in *Bellas Hess*. . . the Court's choice to abstain from rejecting the *Bellas Hess* rule for sales and use taxes fails to argue persuasively that the rule should, for lack of rejection, be augmented to cover other types of tax.

Lanco, 879 A.2d at 1239-40.

The Washington Court of Appeals, in a case involving the income-based taxation of an out-of-state automaker that claimed to have no physical presence in Washington, held that "[a]ny corporation that regularly exploits the markets of a state should be subject to its jurisdiction to impose an income tax even though not physically present." *General Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1029 (Wash. Ct. App. 2001). The court held that the tax at issue was constitutional, finding that

> [t]he tax at issue here is neither a sales or use tax, nor is it a franchise tax. It is a business and occupation tax for the privilege of engaging in business within the City of Seattle. The automakers certainly exploit the market in the City, regardless of where they are physically located. We decline to extend *Quill*'s physical presence requirement in this context.

Id. at 1029. *See also Couchot v. State Lottery Commission*, 659 N.E.2d 1225, 1230 (Ohio 1996) ("There is no indication in Quill that the Supreme Court will extend the physical-presence requirement to cases involving taxation measured by income derived from the state. . . . Thus, the physical-presence requirement of *Quill* is not applicable to the case sub judice"); *Borden Chemicals and Plastices, L.P. v. Zehnder*, 726 N.E.2d 73, 80 (Ill. App. Ct. 2000)

("Plaintiff argues that in *Quill*, the Supreme Court 'left open' the question of whether a physical presence is required in order to satisfy the substantial nexus requirement in other tax cases. We disagree.").

On the basis of the foregoing, the Board ruled, consistent with the overwhelming weight of authority from the Supreme Court and those jurisdictions that have addressed the question, that the physical-presence requirement in *Quill* is not applicable to an income-based excise such as the FIET. Rather, guided by the above precedents, the Board ruled that the Banks' deliberate and targeted exploitation of the Massachusetts economic market and its use of the commonwealth's governmental infrastructure and resources constitute "substantial nexus" under the *Complete Auto* test.

The Banks' derived substantial economic gain from the Massachusetts market through a sophisticated marketing campaign that targeted Massachusetts customers and by use of the Visa and MasterCard network, which included Massachusetts retailers and their "acquiring banks" as well as Massachusetts consumers armed with "Capital One"-branded credit cards. The customer's use of the Capital One cards provided the user with instant buying and borrowing power and informed merchants that the Banks were guaranteeing prompt payment for the goods or services purchased by the customers, since the Banks assumed all credit risk and paid the merchant its charges, less the "merchant discount" charged by the Banks and the acquiring banks. It was the financial resources and stability of the Banks, as represented by the Capital One logo on the credit cards, together with the Visa and MasterCard networks of which the Banks were a part, that en-

abled the transactions from which the Banks derived substantial revenue to occur. Accordingly, like the *Geoffrey*-line of cases, the use of Capital One's intangible property - the Capital One trademark on the cards - within the Massachusetts economic market to generate substantial revenue further supports the Board's ruling that there was substantial nexus. *See, e.g., Kmart*, 139 N.M at 186.

The Banks' expert witnesses, who offered opinions from an economic and policy perspective that the physical presence of a corporation should be required before an state may exact a tax, were unpersuasive. It is the policy of the Legislature as embodied in the language of the FIET, and the legal precedents of the Supreme Court, the Supreme Judicial Court and state courts of competent jurisdiction that govern the question of whether the FIET is constitutional and whether the Banks were appropriately assessed the FIET for the years at issue. As the Supreme Court has observed:

> Nothing can be less helpful than for courts to go beyond the extremely limited restrictions that the Constitution places upon the states and to inject themselves in a merely negative way into the delicate processes of fiscal policy-making. We must be on guard against imprisoning the taxing power of the states within formulas that are not compelled by the Constitution but merely represent judicial generalizations exceeding the concrete circumstances which they profess to summarize.

Wisconsin v. J.C. Penney, 311 U.S. 435, 445 (1940).

For all of the foregoing reasons, the Board ruled that the FIET is constitutional under the Commerce Clause.

III. THE FIET IS A REASONABLE EXCISE ON A COMMODITY

Massachusetts Constitution Part II, c. 1, § 1, Art. 4 provides in pertinent part that:

> full power and authority are given to the general court. . . to impose and levy reasonable duties and excises, upon any produce, goods, wares, merchandise, and commodities, whatsoever, brought into, produced, manufactured, or being within the same. . .

Accordingly, an excise must meet two requirements: it must be reasonable and it must be levied upon produce, goods, wares, merchandise or commodities.

An excise is unreasonable if it is "unjustly discriminatory, arbitrary, whimsical or irrational." *American Uniform Co. v. Commonwealth*, 237 Mass. 42, 45 (1921). "The court cannot declare a tax or excise illegal and void, as being unreasonable, unless it is unequal, or plainly and grossly oppressive, and contrary to common right." *Connecticut Mut. Life Ins. Co. v. Commonwealth*, 133 Mass. 161, 163 (1882). Wide discretion is given to the Legislature in determining what is subject to an excise, as well as its amount and the standard or measure to be adopted as its foundation. *Id.* The provision that an excise must be "reasonable" was not designed to give the judiciary the right to revise the Legislature's decisions in regard to the policy and expediency of an excise. *Id.*

The FIET is imposed uniformly on financial institutions engaged in business in Massachusetts.

Through their Massachusetts business activities, financial institutions such as the Banks avail themselves of the Commonwealth's laws, protections, and privileges, and thus the FIET is not unequal, plainly or grossly oppressive or contrary to common right. The FIET is not arbitrary or irrational, as it is directly related to the privileges that financial institutions receive from the right to engage in business and to sell their services in Massachusetts. *Greenfield Sav. Bank v. Commonwealth*, 211 Mass. 207, 210 (1912).

The FIET, which is based on net income apportioned to Massachusetts, is also reasonably calculated. *See Andover Sav. Bank* 387 Mass. at 236 ("[T]he value of transacting business as a savings bank or cooperative bank lies... in the benefits that are enjoyed by the depositors and borrowers."). The court held in *Andover Savings* the income-based portion of an excise was reasonable as "[i]t measures the value of the bank's investment function according to the returns that are realized for the benefit of its depositors. . . Greater precision in measuring the value of the privilege is not constitutionally required." *Id.*

The FIET also satisfies the constitutional requirement that an excise be levied upon produce, goods, wares, merchandise or commodities. *See Opinion of the Justices to the Governor*, 408 Mass. 1201, 1213 (1990). The FIET taxes the commodity of the right and privilege of doing business and the sale of financial services in the Commonwealth. *See Greenfield Sav. Bank*, 211 Mass. at 210.

"The power to determine what callings, franchises, or privileges, or, to use the language of the Constitution, 'commodities,' shall be subjected to an excise, and the amount of the excise belongs exclu-

sively to the Legislature." *Connecticut Mut. Life Ins. Co.*, 133 Mass. at 163. "The language of the Constitution of Massachusetts is general, and may well be held to authorize the laying of excises upon all such gainful employments and privileges as are created or may be regulated by law, and commonly have been considered legitimate subject of taxation in other States and countries." *Minot v. Winthrop*, 162 Mass 113, 122 (1894).

The term "'[c]ommodity'. . . includes the privilege and convenience of transacting a particular business; and, upon persons carrying on such business, it has never been questioned that the Legislature may levy an excise, or provide that a license must be obtained in order to transact it." *Commonwealth, by Commissioner of Sav. Banks v. Lancaster Sav. Bank*, 123 Mass. 493, 495 (1878). For purposes of the Massachusetts Constitution, a commodity "will perhaps embrace every thing which may be a subject of taxation," and, more specifically, it "has been applied by our legislature, from the earliest practice under the Constitution, to the privilege of using particular branches of business or employment." *President, Dirs., & Co. of the Portland Bank v. Apthorp*, 12 Mass. 252, 256 (1815).

The sale of services is a commodity and can be constitutionally taxed as an activity that may be regulated by Massachusetts, even if it is not in fact regulated. *Opinion of the Justices*, 408 Mass. at 1213 (citing *Minot*, 162 Mass. at 122). The word "commodity" is not limited to tangible personal property, and includes those benefits, privileges, and activities that may be regulated by the Commonwealth. *Id.* Therefore, the FIET, an excise upon the sale of financial services and the privilege to do business in Massachusetts, falls within the Legislature's authority un-

der Massachusetts Constitution Part II, c. 1, § 1, Art. 4.

The FIET clearly manifests the Legislature's intent to impose an excise on financial institutions as compensation for the convenience and privilege of conducting business, and falls within the parameters of the Massachusetts Constitution. The Banks have substantially benefited from their right to do business in Massachusetts, receiving almost $360 million in accounts receivable from Massachusetts customers during the years at issue. The Banks have used the Commonwealth's infrastructure and laws to facilitate transactions with Massachusetts merchants and customers, and participated in the Visa and MasterCard networks, which included acquiring banks in Massachusetts. They have also acquired revenue by charging fees to Massachusetts customers in exchange for financial services, and therefore a reasonable excise may fairly be imposed on them. The fees were "sources of emolument and profit, not strictly called property, but which are rather to be considered as the means of acquiring property, from which a reasonable revenue may be exacted by the legislature." *Portland Bank*, 12 Mass. at 255. In exchange for these privileges, the state has imposed a reasonable excise on the Banks.

The Banks have set forth no persuasive argument or evidence that the FIET was unreasonable or improperly imposed under the Massachusetts Constitution. The Banks have therefore failed to meet their burden of showing that the FIET was unconstitutional. *See Boston v. Keene Corp.*, 406 Mass. 301, 305 (1989) ("The party challenging the statute's constitutionality must demonstrate beyond a reasonable doubt . . . that there are no 'conceivable grounds' which could support its validity.").

IV. CONCLUSION

On the basis of the foregoing, the Board ruled that the FIET is constitutional under the Constitutions of both the United States and Massachusetts. The Banks each clearly fall within the plain terms of the FIET: as banks, they are "financial institutions" and they meet the statutory presumption of being "engaged in business" by conducting activities "with one hundred or more residents of the commonwealth," and received "in excess of five hundred thousand dollars in receipts attributable to sources within the commonwealth."

In fact, the number of Massachusetts residents carrying COB credit cards rose from slightly fewer than 200,000 to more than 460,000 during the years at issue and FSB's Massachusetts customers rose from less than 4,000 to more than 7,000 during that period. COB's receivables related to Massachusetts customers grew from $72,162,796 to $113,655,624 during the years at issue, while FSB's Massachusetts receivables grew from $11,457,826 to $16,588,914. These receivables attributable to Massachusetts customers resulted in income of over $154 million for COB and $8.8 million for FSB for the years at issue. These figures vastly exceed the statutory amounts.

Therefore, the Board ruled that the FIET is constitutional and validly imposed on the Banks for each of the tax years at issue. Accordingly, the Board issued decisions for the appellee in these appeals.

By: Frank J. Scharaffa
Commissioner

APPENDIX C

MASSACHUSETTS GENERAL LAWS
PART I. ADMINISTRATION OF THE GOVERNMENT

TITLE IX. TAXATION

CHAPTER 63. TAXATION OF CORPORATIONS

TAXATION OF BANKS, TRUST COMPANIES, ETC.

Chapter 63: Section 1. Definitions

Section 1. When used in sections one to two A, inclusive, and section thirty-eight B, the following words shall, unless the context otherwise requires, have the following meaning:

"Billing address", the location indicated in the books and records of the taxpayer on the first day of the taxable year, or on such later date in the taxable year when the customer relationship began, as the address where any notice, statement or bill relating to a customer's account is mailed.

"Borrower or credit card holder located in this commonwealth", (a) a borrower, other than a credit card holder, that is engaged in a trade or business which maintains its commercial domicile in this commonwealth; or (b) a borrower that is not engaged in a trade or business or a credit card holder whose billing address is in this commonwealth.

"Code", the Internal Revenue Code of the United States, as amended and in effect for the taxable year, unless otherwise provided.

"Commercial domicile", (a) the headquarters of the trade or business, that is, the place from which the trade or business is principally managed and directed; or (b) if a taxpayer is organized under the laws of a foreign country, or of the Commonwealth of Puerto Rico, or any territory or possession of the United States, such taxpayer's commercial domicile shall be deemed to be the state of the United States or the District of Columbia from which such taxpayer's trade or business in the United States is principally managed and directed. It shall be presumed, subject to rebuttal, that the location from which the taxpayer's trade or business is principally managed and directed is the state of the United States or the District of Columbia to which the greatest number of employees are regularly connected or out of which they are working, irrespective of where the services of such employees are performed, as of the last day of the taxable year.

"Compensation", wages, salaries, commissions and any other form of remuneration paid to employees for personal services that are included in such employee's gross income under the Internal Revenue Code. In the case of employees not subject to the Internal Revenue Code, such as those employed in foreign countries, the determination of whether such payments would constitute gross income to such employees under the Internal Revenue Code shall be made as though such employees were subject to the Internal Revenue Code.

"Credit card", credit, travel or entertainment card.

"Credit card issuer's reimbursement fee", the fee a taxpayer receives from a merchant's bank because one of the persons to whom the taxpayer has issued a credit card has charged merchandise or services to the credit card.

"Employee", with respect to a particular taxpayer, any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee of that taxpayer.

"Engaged in business in the commonwealth", (a) having a business location in the commonwealth; (b) having employees, representatives or independent contractors conducting business activities on its behalf in the commonwealth; (c) maintaining, renting or owning any tangible or real property in the commonwealth; (d) regularly performing services in the commonwealth; (e) regularly engaging in transactions with customers in the commonwealth that involve intangible property and result in income flowing to the taxpayer from residents of the commonwealth; (f) regularly receiving interest income from loans secured by tangible personal or real property located in the commonwealth; or (g) regularly soliciting and receiving deposits from customers in the commonwealth. With respect to the activities described in clauses (d) to (g), inclusive, activities shall be presumed, subject to rebuttal, to be conducted on a regular basis within the commonwealth, if any of such activities are conducted with one hundred or more residents of the commonwealth during any taxable year or if the taxpayer has ten million dollars or more of assets attributable to sources within the commonwealth, or has in excess of five hundred thousand dollars in receipts attributable to sources within the commonwealth.

[Definition of "Financial institution" effective until July 3, 2008. For text effective July 3, 2008, see below.]

"Financial institution", (a) any bank, banking association, trust company, federal or state savings and loan association, including all banks for cooperatives organized under the United States Farm Credit Act of 1933, whether of issue or not, existing by authority of the United States, or any state, or a foreign country, or any law of the commonwealth; (b) any other institution, association or entity, the deposits or accounts of which are insured under the Federal Deposit Insurance Act or by the Federal Deposit Insurance Corporation, any institution, association or entity, which is a member of a federal Home Loan Bank, excluding corporations described in section 1 of chapter 171, any other bank or thrift institution incorporated or organized under the laws of a state which is engaged in the business of receiving deposits, any corporation organized under the provisions of 12 USC 611-631 and 12 USC 3101; (c) any corporation subject to chapter 167A, or registered under the Federal Bank Holding Company Act of 1956, or registered as a savings and loan holding company under federal law, but excluding a diversified savings and loan holding company unless it satisfies the definition of a financial institution elsewhere herein, including any subsidiary which participates in the filing of a consolidated return of income to the federal government; (d) any corporation subject to supervision by the division of banks including but not limited to corporations described in section 24 of chapter 93, sections 96 to 104, inclusive, or section 114C of chapter 140; section 38 of chapter 167; section 5 of chapter 167B; chapter 169A; chapter 255B; chapter 255C; chapter 255D; and chapter 255E; or (e) any

other corporation organized under the laws of the United States, the commonwealth or any other state or a foreign country which, in substantial competition with financial institutions as defined in any or all of clauses (a) to (d), inclusive, derives more than 50 per cent of its gross income, excluding nonrecurring, extraordinary items, from loan origination, from lending activities, including discounting obligations, or from credit card activities; but, corporations described in section 1 of chapter 171 shall be excluded from the definition of financial institution.

[Definition of "Financial institution" as amended by 2008, 173, Sec. 28 effective July 3, 2008 for tax years beginning on or after January 1, 2009. See 2008, 173, Sec. 101. For text effective until July 3, 2008, see above.]

"Financial institution", (a) any bank, banking association, trust company, federal or state savings and loan association, including all banks for cooperatives organized under the United States Farm Credit Act of 1933, whether of issue or not, existing by authority of the United States, or any state, or a foreign country, or any law of the commonwealth; (b) any other institution, association or entity, the deposits or accounts of which are insured under the Federal Deposit Insurance Act or by the Federal Deposit Insurance Corporation, any institution, association or entity, which is a member of a federal Home Loan Bank, excluding corporations described in section 1 of chapter 171, any other bank or thrift institution incorporated or organized under the laws of a state which is engaged in the business of receiving deposits, any corporation organized under the provisions of 12 USC 611-631 and 12 USC 3101; (c) any corporation subject to chapter 167A, or registered under the Federal Bank Holding Company Act of 1956, or reg-

istered as a savings and loan holding company under federal law, but excluding a diversified savings and loan holding company unless it satisfies the definition of a financial institution elsewhere herein, including any subsidiary which participates in the filing of a consolidated return of income to the federal government; (d) any corporation subject to supervision by the division of banks including but not limited to corporations described in section 24 of chapter 93, sections 96 to 104, inclusive, or section 114C of chapter 140; section 38 of chapter 167; section 5 of chapter 167B; chapter 169A; chapter 255B; chapter 255C; chapter 255D; and chapter 255E; or (e) any other corporation organized under the laws of the United States, the commonwealth or any other state or a foreign country which, in substantial competition with financial institutions as defined in any or all of clauses (a) to (d), inclusive, derives more than 50 per cent of its gross income, excluding nonrecurring, extraordinary items, from loan origination, from lending activities, including discounting obligations, or from credit card activities; but, corporations described in section 1 of chapter 171 shall be excluded from the definition of financial institution. The term "corporation" as used in this definition shall mean any corporation, or any "other entity" as defined in section 1.40 of chapter 156D, whether the corporation or other entity may be formed, organized, or operated in or under the laws of the commonwealth or any other jurisdiction, that is classified for the taxable year as a corporation for federal income tax purposes.

"Gross income", gross income as defined under the provisions of the Internal Revenue Code, as amended and in effect for the taxable year, plus the

interest from bonds, notes and evidences of indebtedness of any state, including this commonwealth.

"Gross rents", the actual sum of money or other consideration payable for the use or possession of property. "Gross rents" shall include, but not be limited to:

(a) any amount payable for the use or possession of real property or tangible property whether designated as a fixed sum of money or as a percentage of receipts, profits or otherwise;

(b) any amount payable as additional rent or in lieu of rent, such as interest, taxes, insurance, repairs or any other amount required to be paid by the terms of a lease or other arrangement; and

(c) a proportionate part of the cost of any improvement to real property made by or on behalf of the taxpayer which reverts to the owner or lessor upon termination of a lease or other arrangement. The amount to be included in gross rents shall be the amount of amortization or depreciation allowed in computing the taxable income base for the taxable year; provided, however, where a building is erected on leased land by or on behalf of the taxpayer, the value of the land shall be determined by multiplying the gross rent by eight and the value of the building shall be determined in the same manner as if owned by the taxpayer.

(d) the following shall not be included in the term "gross rents":

(i) reasonable amounts payable as separate charges for water, steam, and electric service furnished by the lessor;

(ii) reasonable amounts payable as service charges for janitorial services furnished by the lessor;

(iii) reasonable amounts payable for storage, provided such amounts are payable for space not designated and not under the control of the taxpayer; and

(iv) that portion of any rental payment which is applicable to the space subleased from the taxpayer and not used by it.

"Loan", any extension of credit resulting from direct negotiations between the taxpayer and its customer, or the purchase, in whole or in part, of such extension of credit from another. Loans include participations, syndications and leases treated as loans for federal income tax purposes. Loans shall not include: properties treated as loans under section 595 of the Internal Revenue Code; futures or forward contracts; options; notional principal contracts such as swaps; credit card receivables, including purchased credit card relationships; non-interest bearing balances due from depository institutions; cash items in the process of collection; federal funds sold; securities purchased under agreement to resell; assets held in a trading account; securities; interests in a REMIC as defined in section 860D of the Internal Revenue Code, or other mortgage-backed or asset-backed security; and other similar items.

"Loan secured by real property", a loan in which fifty percent or more of the aggregate value of the collateral, when valued at fair market value as of the time the original loan was incurred, was real property.

"Merchant discount", the fee or negotiated discount charged to a merchant by the taxpayer for the privilege of participating in a program whereby a

credit card is accepted in payment for the merchandise or services sold to the card holder.

"Net income", gross income, other than ninety-five percent of dividends received in any taxable year beginning on or after January first, nineteen hundred and ninety-nine from or on account of the ownership of any class of stock if the financial institution owns fifteen percent or more of the voting stock of the institution paying the dividend, less the deductions, but not the credits allowable under the provisions of the Internal Revenue Code, as amended and in effect for the taxable year. The term "dividends received' shall be treated in the same manner as under the Code, as amended and in effect for the taxable year. The term "dividends received", as it relates to distribution from a real estate investment trust, as provided in sections 856 to 859, inclusive, of the Code, shall be treated in the same manner as under the Code, as amended and in effect for the taxable year. For purposes of this section, any dividend received directly or indirectly from the real estate investment trust shall not be treated as a dividend. Any dividend received directly or indirectly from a regulated investment company, as provided in sections 851 to 855, inclusive, of the Code, shall not be included as part of the dividends received deduction otherwise available under this section. For taxable years beginning on or after January first, nineteen hundred and ninety-nine, the provisions of section two hundred and ninety-one of said Code shall not apply; and the provisions of section one hundred and seventy-one (a)(2) and two hundred and sixty-five of said Code shall only apply to the extent that the income to which the deductions relate is excludable from gross income. Deductions with respect to

the following items, however, shall not be allowed except as otherwise provided:

(a) dividends received, except as otherwise provided;

(b) losses sustained in other taxable years;

(c) taxes on or measured by income, franchise taxes measured by net income, franchise taxes for the privilege of doing business and capital stock taxes imposed by a state;

(d) the deduction allowed by section 168(k) of the Code; or

(e) the deduction allowed by section 199 of the Code.

"Participation", an extension of credit in which an undivided ownership interest is held on a pro rata basis in a single loan or pool of loans and related collateral. In a loan participation, the creditor originator initially makes the loan and then subsequently resells all or a portion of it to other lenders. The participation may or may not be known to the borrower.

"Person", an individual, estate, trust, partnership, corporation and any other business entity.

"Principal base of operations", with respect to transportation property means the place of more or less permanent nature from which said property is primarily directed or controlled. With respect to an employee, the "principal base of operations" means the place of more or less permanent nature from which the employee primarily (1) starts his work and to which he customarily returns in order to receive instructions from his employer or (2) (if (1) is not applicable) communicates with his customers or other persons, or (3) (if (1) and (2) are both not applicable)

performs any other functions necessary to the exercise of his trade or profession.

"Real property owned" and "tangible personal property owned", real and tangible personal property respectively, (1) on which the taxpayer may claim depreciation for federal income tax purposes, or (2) property to which the taxpayer holds legal title and on which no other person may claim depreciation for federal income tax purposes, or could claim depreciation if subject to federal income tax. Real and tangible personal property do not include coin, currency, or property acquired in lieu of or pursuant to a foreclosure.

"Regular place of business", an office at which the taxpayer carries on its business in a regular and systematic manner and which is consistently maintained, occupied and used by employees of the taxpayer.

"State", a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States; any foreign country; or a political subdivision of any of the foregoing.

"Syndication", an extension of credit in which two or more persons fund and each person is at risk only up to a specified percentage of the total extension of credit or up to a specified dollar amount.

"Taxable", (a) that a taxpayer is subject in another state to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, a corporate stock tax, including a bank shares tax, a single business tax, or an earned surplus tax, or any tax which is imposed upon or measured by net income; or (b) that another state has jurisdiction to subject the taxpayer to any

of such taxes regardless of whether, in fact, the state does or does not.

"Taxable year", any fiscal or calendar year or period for which the taxpayer is required to make a return to the federal government; or the period for which a return is made by the taxpayer, if a return is made (1) for a period less than twelve months, or (2) for a period for which no return to the federal government is required.

"Taxpayer", a financial institution engaged in business in the commonwealth.

"Transportation property", vehicles and vessels capable of moving under their own power, including, but not limited to, aircraft, trains, water vessels and motor vehicles, as well as any equipment or containers attached to such property, such as rolling stock, barges, trailers or the like.

APPENDIX D

Massachusetts General Laws
PART I. ADMINISTRATION OF THE GOVERNMENT

TITLE IX. TAXATION

CHAPTER 63. TAXATION OF CORPORATIONS

TAXATION OF BANKS, TRUST COMPANIES, ETC.

Chapter 63: Section 2. Financial institutions; excise rate

[Subsection (a) effective until July 3, 2008. For text effective July 3, 2008, see below.]

Section 2. (a) Except as provided in subsection (b), every financial institution engaged in business in the commonwealth shall pay, on account of each taxable year, an excise measured by its net income determined to be taxable under section two A at the following rate: taxable years beginning on or after January first, nineteen hundred and ninety-five but before January first, nineteen hundred and ninety-six, twelve and thirteen hundredths percent; on or after January first, nineteen hundred and ninety-six but before January first, nineteen hundred and ninety-seven, eleven and seventy-two hundredths percent; on or after January first, nineteen hundred and ninety-seven but before January first, nineteen hundred and ninety-eight, eleven and thirty-two hundredths percent; on or after January first, nine-

teen hundred and ninety-eight but before January first, nineteen hundred and ninety-nine, ten and ninety-one hundredths percent; on or after January first, nineteen hundred and ninety-nine, ten and one-half percent; provided, however, that the excise imposed hereunder shall be no less than four hundred and fifty-six dollars.

[Subsection (a) as amended by 2008, 173, Sec. 29 effective July 3, 2008 for tax years beginning on or after January 1, 2009. See 2008, 173, Sec. 101. For text effective until July 3, 2008, see above.]

(a) Except as provided in subsections (b) and (d), every financial institution engaged in business in the commonwealth shall pay, on account of each taxable year, an excise measured by its net income determined to be taxable under section two A at the following rate: taxable years beginning on or after January first, nineteen hundred and ninety-five but before January first, nineteen hundred and ninety-six, twelve and thirteen hundredths percent; on or after January first, nineteen hundred and ninety-six but before January first, nineteen hundred and ninety-seven, eleven and seventy-two hundredths percent; on or after January first, nineteen hundred and ninety-seven but before January first, nineteen hundred and ninety-eight, eleven and thirty-two hundredths percent; on or after January first, nineteen hundred and ninety-eight but before January first, nineteen hundred and ninety-nine, ten and ninety-one hundredths percent; on or after January first, nineteen hundred and ninety-nine, ten and one-half percent; provided, however, that the excise imposed hereunder shall be no less than four hundred and fifty-six dollars.

[Subsection (b) effective until July 3, 2008. For text effective July 3, 2008, see below.]

(b) Any corporation taxable under this section and described in clause (c), (d) or (e) of the definition of "financial institution" in section one, but not described in clause (a) or (b) of said definition, shall pay on account of each taxable year beginning on or after January first, nineteen hundred and ninety-five an excise measured by its net income determined to be taxable under section two A at the rate of ten and one-half percent; provided, however, that the excise imposed hereunder shall be no less than four hundred and fifty-six dollars.

[Subsection (b) as amended by 2008, 173, Sec. 30 effective July 3, 2008 for tax years beginning on or after January 1, 2009. See 2008, 173, Sec. 101. For text effective until July 3, 2008, see above.]

(b) Any corporation taxable under this section shall pay an excise measured by its net income determined to be taxable under section 2A at the following rates:-- (i) for each taxable year beginning on or after January 1, 1995, but before January 1, 2010, 10.5 per cent; (ii) for each taxable year beginning on or after January 1, 2010, but before January 1, 2011, 10.0 per cent; (iii) for each taxable year beginning on or after January 1, 2011, but before January 1, 2012, 9.5 per cent; or (iv) for each taxable year beginning on or after January 1, 2012 and thereafter, 9.0 per cent; provided, however, that in no case shall the excise imposed under this section amount to less than $456.

(c) The commissioner is hereby authorized to adjust the net income of any taxpayer in accordance with the provisions of and the rules and regulations

under section 482 of the Internal Revenue Code, as amended from time to time.

[Subsection (d) added by 2008, 173, Sec. 31 effective July 3, 2008 for tax years beginning on or after January 1, 2009. See 2008, 173, Sec. 101.]

(d) Any financial institution that is an S corporation, as defined in section 1361 of the Code, shall not be subject to the tax provided in subsections (a) and (b) and shall instead be subject to the excise in section 2B.

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(6)

Supreme Court, U.S.
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No. 08-1169

IN THE
SUPREME COURT OF THE UNITED STATES

CAPITAL ONE BANK (USA), N.A.,
F/K/A CAPITAL ONE BANK, AND CAPITAL ONE, N.A.,
AS SUCCESSOR TO CAPITAL ONE F.S.B.,
Petitioners,

v.

COMMISSIONER OF REVENUE OF MASSACHUSETTS,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE SUPREME JUDICIAL COURT OF
MASSACHUSETTS

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether the Commerce Clause permits a State to impose a corporate net income tax---one conceded by the taxpayer to be fairly apportioned, non-discriminatory, and fairly related to the services provided by the State---on a taxpayer regularly engaging in transactions involving intangible property with residents in that State, in the absence of a "physical presence" by the taxpayer in the taxing State.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Constitutional and Statutory Provisions

Other Authorities

INTRODUCTION

Pursuant to Supreme Court Rule 15, respondent Commissioner of Revenue of Massachusetts submits this brief in opposition to the petition for a writ of certiorari. The writ should be denied in this case because (1) the decision of the Massachusetts Supreme Judicial Court ("SJC") is consistent with the decisions of this Court and the requirement that a state tax be applied to "an activity with a substantial nexus with the taxing State"; (2) the decision of the SJC enlarges a growing consensus of the States' highest courts rejecting the claim that the Commerce Clause requires a "physical presence" in order to establish a "substantial nexus"; (3) the Court should not grant review based on mere speculation about burdens on interstate and foreign commerce; and (4) the Court should deny review in deference to the constitutional role of Congress in weighing the burdens on interstate commerce.

OPINIONS BELOW, JURISDICTION, AND CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Respondent accepts petitioners' citations concerning the opinions below, the jurisdiction of the Court, and the constitutional and statutory provisions involved.

STATEMENT

The Mass. Financial Institution Excise Tax

The Commissioner is the Massachusetts official authorized to enforce the tax laws of the Commonwealth. Mass. Gen. Laws ch. 14, §§ 1-3; ch. 62C, § 3. She is charged with enforcing the excise tax imposed on financial institutions "engaged in +business in the commonwealth." *See* Mass. Gen. Laws ch. 63, § 2. Capital One Bank ("COB") and Capital One FSB ("FSB" and, together with COB, the "petitioners") do not contest that they are "financial institutions" as defined by Mass. Gen. Laws ch. 63, § 1. Nor do they contest that they are financial institutions "engaged in business in the commonwealth" under the Massachusetts Financial Institutions Excise Tax ("FIET"). The statute defines that phrase as follows:

> (a) having a business location in the commonwealth; (b) having employees, representatives or independent contractors conducting business activities on its behalf in the commonwealth; (c) maintaining, renting or owning any tangible or real property in the commonwealth; (d) regularly performing services in the commonwealth; *(e) regularly engaging in transactions in the commonwealth that involve intangible property and result in income flowing to the taxpayer from residents of the commonwealth;* (f)

> regularly receiving interest income from loans secured by tangible property or real property located in the commonwealth; or (g) regularly soliciting and receiving deposits from customers in the commonwealth. *With respect to the activities described in clauses (d) to (g), inclusive, activities shall be presumed, subject to rebuttal, to be conducted on a regular basis within the commonwealth if any of such activities are conducted with one hundred or more residents of the commonwealth during any taxable year or if the taxpayer has ten million dollars or more of assets attributable to sources within the commonwealth, or has in excess of five hundred thousand dollars in receipts attributable to sources within the commonwealth.*

Mass. Gen. Laws ch. 63, § 1 (emphasis added). The FIET was enacted in 1995. Mass. St. 1995, c. 81, § 1.

The FIET is based on a percentage of a financial institution's net income. Mass. Gen. Laws ch. 63, § 2. Out-of-state financial institutions conducting business both within and without Massachusetts are allowed to apportion their net income based on a statutorily-defined apportionment scheme not challenged in this case. *See* Mass. Gen. Laws ch. 63, § 2A.

Proceedings before the Commissioner of Revenue, the Appellate Tax Board, and Supreme Judicial Court

COB failed to file FIET returns for the taxable years 1995 through 1998. App. 8a, 24a. Similarly, FSB failed to file FIET returns for the taxable years 1996 through 1998. App. 8a, 24a. After notifying the petitioners that they had failed to file, and based on apportionment information provided by the petitioners, the Commissioner assessed taxes against COB in the amount of $1,758,454.96 and against FSB in the amount of $159,075. App 8a, 24a.

Petitioners filed applications for abatement, which the Commissioner denied. App. 8a-9a, 24a. Petitioners appealed the Commissioner's decisions to the Appellate Tax Board (the "Board"). App. 9a, 24a. Following a hearing, the Board issued its decision upholding the Commissioner's denial of abatements. App. 9a-10a, 30a-31a. The Board later issued its Findings of Fact and Report. A. 23a-53a, 2007 WL 1810723 (Mass. App. Tax Board June 22, 2007). The Board rejected petitioners' claim that the Commerce Clause requires that the taxpayer have a physical presence in the taxing State before the State may assess an excise tax based on a corporation's net income from activities conducted within the States. App. 35a-49a. The Board found that petitioners' activities in Massachusetts created the "substantial nexus" required by the Commerce Clause. *Id.* The Board found that these activities included, among other things, substantial, targeted marketing to

Massachusetts customers; millions of dollars in loan receivables; the derivation of hundreds of millions of dollars in income from millions of transactions involving Massachusetts residents and merchants; the use of the Massachusetts court system to collect delinquent accounts; and the use of the Massachusetts Attorney General's Office to resolve disputes with Massachusetts customers. App. 30a-31a, 47a-48a.

The petitioners appealed the Board's decision. The Supreme Judicial Court (SJC) granted their application for direct appellate review. App. 2a. The SJC affirmed. App. 1a-22a. The SJC first described the many activities conducted by the petitioners in Massachusetts and noted that they had not "rebutted the statutory presumption that they have regularly engaged in business in Massachusetts." App. 2a-8a, 12a. Turning to the claim under the Commerce Clause, the court surveyed the decisions of this Court in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967), and *Quill v. North Dakota*, 504 U.S. 298 (1992). The SJC stated that "*Quill* explicitly emphasized, on more than one occasion, a narrow focus on sales and use taxes for the physical presence requirement . . . and did not apply to the imposition of other types of state taxes." App. 17a. Citing the decision of the West Virginia Supreme Court in *Tax Comm'r of W. Va. v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006), *cert. denied sub nom. FIA Card Services, N.A. v. Tax Comm'r of W. Va.*, 127 S.Ct. 2997 (2007), the SJC "conclude[d] that

the constitutionality, under the commerce clause, of the . . . FIET is determined not by *Quill*'s physical presence test, but by the 'substantial nexus' test articulated in *Complete Auto*." App. 21a-22a. The court then considered the facts set forth below and concluded that the petitioners' "activities in Massachusetts established a substantial nexus with the Commonwealth." App. 22a.

Facts Concerning the Petitioners' Activities in Massachusetts

Pursuant to Supreme Court Rule 15, the respondent supplements the petitioners' statement of the case with the following facts drawn from the decisions of the Board and the SJC. *See* Pet. App. 1a-9a; 23a-31a.

During the years at issue, COB was a Virginia chartered credit card bank offering credit card products. App. 2a-3a, 24a-25a. FSB was a federally chartered savings bank offering lending and deposit products, including secured and unsecured credit cards, to individuals and small businesses. App. 3a, 24a-25a. Both banks were wholly owned subsidiaries of Capital One Financial Corporation ("COFC") and maintained commercial domiciles in Virginia. App. 2a-3a, 24a-25a.

Petitioners' primary assets were consumer loans using "Capital One" credit cards as the credit extension vehicle. App. 4a, 25a. COFC is the owner of the trademark "Capital One" and provides the trademark to the petitioners free of license and

royalty to appear on credit cards issued to consumers in Massachusetts. *Id.* Both COB and FSB generated income through finance charges assessed on outstanding loan receivables, fees from credit card transactions, and interest income earned on investment securities and money market investments. App. 8a, 25a.

Petitioners employed a statistical marketing technique to target potential consumers in Massachusetts, primarily through interstate mailings. *See* App. 4a. Petitioners also solicited credit card customers through the internet, outbound telephone communications, and newspaper advertisements, and through third parties at marketing events and at retail establishments. Board Exh. 892; *see* App. 4a, 8a. As a result of petitioners' marketing efforts in Massachusetts, the number of Massachusetts residents with COB credit cards rose from 196,000 in 1995 to 465,000 in 1998, and FSB's Massachusetts customers grew from 3,800 to 7,363 in 1998, the years at issue. App. 8a, 26a. Petitioners spent more than $10 million to acquire Massachusetts customers during the years at issue, given their marketing expenditure of between $50 and $100 per individual cardholder. *Id.*

Petitioners generated millions of dollars of income from the acquisition of customers in Massachusetts. *Id.* During the years at issue, COB's outstanding loan receivables related to Massachusetts customers grew from roughly $72 million to more than $113 million, while FSB's receivables grew from $11.5 million to $16.6 million.

Id. The receivables generated income for the petitioners in the form of interest, fees, and penalties. *Id.* COB's income from Massachusetts customers rose from $22 million in 1995 to almost $58 million in 1998, while FSB's Massachusetts income rose from $1.5 million in 1996 to more than $3 million in both 1997 and 1998. *Id.*

Through their agreements with Massachusetts residents, petitioners issued "general purpose" credit cards branded with the "Capital One" trademark. App. 6a-7a, 26a-27a. Pursuant to the agreements, petitioners advanced funds on behalf of their Massachusetts customers for transactions in which the customers used the credit cards to purchase goods or services from merchants in Massachusetts and other States. App. 5a, 27a. Customers were also able to obtain cash advances on their credit accounts by using the "Capital One" cards at banks and automated teller machine locations in Massachusetts. *Id.*.

Petitioners were also members of the Visa and MasterCard associations, which gave them access to the technology and equipment necessary to process credit card transactions in Massachusetts and nationwide. App. 5a-6a, 27a. Within the associations, petitioners were considered "issuing banks" because they issued credit cards branded with the Visa or MasterCard logos. App. 6a, 28a. Other members of the associations included "acquiring banks," which maintained contractual arrangements with merchants that accepted Visa or MasterCard. App. 6a, 27a-29a.

Transactions involving petitioners' credit cards were consistent with typical credit card transactions. App. 6a-7a, 27a-28a. When a customer uses a credit card to pay a merchant for goods or services, the merchant relays the credit card information to an acquiring bank. *Id.* The acquiring bank then transmits the transaction information to the relevant association, which in turn routes it to the issuing bank for approval. *Id.* The issuing bank either authorizes or declines the transaction, and relays the decision back through the association and the acquiring bank to the merchant at the point of sale. *Id.* Assuming the transaction is approved and completed, the merchant submits a payment request to the acquiring bank, which forwards the request to the issuing bank. *Id.* The issuing bank then pays the transaction amount to the acquiring bank, minus an "interchange fee." *Id.* The acquiring bank then subtracts its own fee from the amount received, and pays the remainder to the merchant. *Id.*. During the years at issue, petitioners generated more than $16.2 million collectively in interchange fees relative to Massachusetts customers. App. 7a, 28a.

In the event of non-payment by its customers, petitioners worked with collection agencies and attorney networks in Massachusetts to collect delinquent accounts of Massachusetts customers. App. 7a, 29a. These agencies and in-state attorneys provided collection services to petitioners and instituted legal proceedings on behalf of petitioners in Massachusetts courts. *Id.* Petitioners obtained

garnishments, liens against personal property, and writs of execution against real estate located in Massachusetts. *Id.* Petitioners obtained judgments in Virginia courts against Massachusetts customers and then domesticated the judgments to Massachusetts for further enforcement proceedings. App. 7a, 29a-30a. The Massachusetts Attorney General's Office mediated disputes between petitioners and their Massachusetts customers through its Consumer Complaints and Information Section and nineteen Local Consumer Programs. App. 7a-8a, 30a.

REASONS FOR DENYING THE WRIT

I. THE DECISION OF THE SJC IS CONSISTENT WITH *QUILL* AND THE REQUIREMENT IN *COMPLETE AUTO* THAT A STATE TAX BE APPLIED TO "AN ACTIVITY WITH A SUBSTANTIAL NEXUS WITH THE TAXING STATE."

A. The Decision of the SJC Is Consistent with *Quill*'s Express Limitation to Sales and Use Taxes.

Under the Commerce Clause, a State may tax a company engaged in purely interstate commerce provided that the tax is "[1] applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). In

permitting the States to tax purely interstate commerce, *Complete Auto* overruled *Spector Motor Service v. O'Connor*, 340 U.S. 602 (1951)(striking down a Missouri tax on an interstate trucking company). *Id.* *Complete Auto* thus reaffirmed the principle that "interstate commerce may be made to pay its own way." *Id.* at 288-89 n.15.

Here, petitioners concede that the tax is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State. They challenge the tax only under the "substantial nexus" test.

The Court applied the substantial nexus test to the collection of a use tax in *Quill.* A use tax is typically imposed on the storage, use, or consumption of goods or services purchased outside the taxing State for storage, use, or consumption within the taxing State. *See* Mass. Gen. Laws ch. 64I, § 2. The company in *Quill* was an out-of-state mail order house that had no affiliates or representatives, and only *de minimis* tangible or intangible property in the taxing State. The only connection between the company and its customers in the taxing State was "by common carrier or the United States mail." *Quill,* 504 U.S. at 301 (quotation omitted). The Supreme Court of North Dakota had declined to follow *National Bellas Hess, Inc. v. Department of Revenue of Illinois,* 386 U.S. 753, 758 (1967)—another mail-order sales and use tax case—on the ground that the holding was "obsolete." *Id.* Although this Court in *Quill* agreed "with much of the state court's reasoning" and held

that the tax satisfied due process, it reversed the state-court judgment, reaffirmed *National Bellas Hess*, and held that the lack of a physical presence by the taxpayer demonstrated a lack of "substantial nexus" under the Commerce Clause. *Id.*

The rule maintained in *Quill*, however, is not controlling here. In preserving the *National Bellas Hess* rule for sales and use taxes, this Court relied heavily on the principle of *stare decisis*. *Id.* at 311, 317-18. The Court observed that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today." *Id.* at 311, 318. The Court also relied on factors specific to sales and use taxation and the mail-order industry: the Court stated that the rule in *National Bellas Hess* had "engendered substantial reliance and has become part of the basic framework of a sizable industry." *Id.* at 317. Relying on these factors, *Quill* reaffirmed that substantial nexus for a *sales or use tax collection duty* requires the physical presence of the taxpayer in the taxing State, *id.* at 316-17, but carefully noted that it "has not, in [its] review of other types of taxes, articulated the same physical-presence requirement . . . ." *Id.* at 314; *see id.* at 317 ("concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement"). Justice Scalia's concurring opinion, which was joined by Justices Kennedy and Thomas, relied even more heavily on *stare decisis*. *Id.* at 320. Given the Court's express limitation of its holding, and the Court's substantial reliance on the principle of *stare decisis*, there is no basis for the claim that the decision below is in conflict with *Quill*.

B. The Fact-Specific Ruling Below Is Consistent with *Complete Auto* Because the Petitioners' Activities Have a Substantial Nexus with Massachusetts.

The SJC correctly adhered to the Court's express limitation of *Quill* to sales and use taxes and applied the *Complete Auto* test without imposing a threshold requirement that petitioners have a physical presence in Massachusetts. *Complete Auto*'s substantive focus on "activities" readily supports that judgment, given the petitioners' commercial contacts with Massachusetts. As the SJC stated, petitioners "provided valuable financial services . . . using Massachusetts banking and credit facilities," including an extensive network of banks and merchants (App. 5a-6a) and the use of "the Massachusetts court system to recover payments for delinquent accounts." *Id.*

The decision below thus represents a straightforward application of *Complete Auto*'s substantive focus on "activities." In the absence of a governing precedent like *Bellas Hess,* there is no warrant to transform the *Complete Auto* nexus test to demand physical presence as the *sine qua non* of corporate income taxation. Under petitioners' theory, a business employing one person, renting a storefront in Massachusetts, and generating $100,000 of revenue, would have physical presence and thus be subject to taxation; indeed, under *National Geographic Society v. California Bd. of Equalization*, 430 U.S. 551 (1977), the existence of the store-front

would allow taxation even of activities of the business that were unrelated to the building. Yet petitioners, who receive millions of dollars of revenue from interest payments and fees from Massachusetts residents doing business with Massachusetts firms (App. 22a), would be immune from a fairly apportioned, non-discriminatory corporate excise tax. This result is not compelled by *stare decisis*, as in *Quill* (in light of *Bellas Hess*). Indeed, it conflicts with the focus on substance required by *Complete Auto*, which generally requires that interstate commerce "pay its own way." *Id.* at 288-89 n.15. The decision of the SJC is fully consistent with *Complete Auto* and does not warrant review by this Court.

II. RATHER THAN CREATING A CONFLICT AMONG STATE COURTS, THE DECISION OF THE SJC ENLARGES A GROWING CONSENSUS OF THE STATES' HIGHEST COURTS REJECTING THE CLAIM THAT THE COMMERCE CLAUSE REQUIRES A "PHYSICAL PRESENCE" IN ORDER TO ESTABLISH A "SUBSTANTIAL NEXUS."

In determining whether to grant certiorari, the Court generally requires that a conflict of decisions be "real and embarrassing." *Rice v. Sioux City Cemetery*, 349 U.S. 70, 79 (1955) (quotation omitted). In this case, there is no conflict of sufficient degree or type. The overwhelming majority of state courts that have addressed the issue since the decision in *Quill* in 1992 have held

that a physical presence is not required for a State to impose a fairly apportioned, non-discriminatory net income tax on corporations doing business in the taxing State. No state supreme court has held otherwise. The three intermediate appellate court decisions cited by the petitioners—all at least nine years old—do not establish a current and significant conflict of state authority. In fact, any conflict of state decisions, if it had ever reached maturity, is now well past its shelf life.

A year after the decision in *Quill*, the Supreme Court of South Carolina upheld an income-based tax under the Commerce Clause, ruling that substantial nexus was created by the use of the taxpayer's trademarks within the taxing State. *See Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13, 18 (S.C.), *cert. denied*, 510 U.S. 992 (1993). The court held that "by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a 'substantial nexus' with South Carolina." *Id.* In the seventeen years after *Quill*, the clear majority of the state courts that have addressed the issue have similarly declined to apply a physical presence requirement to an income-based tax. *See Geoffrey, Inc. v. Okla. Tax Comm'n*, 132 P.3d 632, 638 (Okla. Civ. App. Ct. 2006)(trademark licensing); *Lanco, Inc. v. Dir., Div. of Taxation*, 908 A.2d 176, 177 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (2007)(same); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004), *cert. denied*, 546 U.S. 821 (2005)(same); *Kmart Props., Inc. v. Taxation and Revenue Dep't*, 131 P.3d 27 (N.M. Ct. App. 2001), *cert. granted*, 40 P.3d 1008

(N.M. 2002), *cert. quashed*, 131 P.3d 22 (N.M. 2005) (same); *Bridges v. Geoffrey, Inc.*, 984 So.2d 115 (La. Ct. App. 2008) (same); *Secretary, Dep't of Revenue v. Gap (Apparel), Inc.*, 886 S.2d 459, 462 (La. Ct. App. 2004) (same); *Comptroller of the Treasury v. SYL, Inc.*, 825 A.2d 399 (Md. 2003)(same); *see also General Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1029 (Wash. Ct. App. 2001); *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225, 1230 (Ohio 1996)("no indication in *Quill* that the Supreme Court will extend the physical presence requirement to cases involving taxation measured by income derived from the state"); *Borden Chems. & Plastics v. Zehnder*, 726 N.E.2d 73, 80 (Ill. App. Ct. 2000)("Plaintiff argues that in *Quill*, the Supreme Court 'left open' the question of whether a physical presence is required in order to satisfy the substantial nexus requirement in other tax cases. We disagree."); *Buehner Block Co. v. Wyoming Dep't of Revenue*, 139 P.3d 1150, 1158 n.6 (Wyo. 2006) (*Bellas Hess* and *Quill* "created [a] specialized jurisprudence" applicable to "sales and use tax case[s]"). The SJC reached the same conclusion in a case involving the licensing of trademarks, *Geoffrey, Inc. v. Commissioner of Revenue*, 899 N.E.2d 87 (Mass. 2009), *petition for cert. filed*, U.S. No. 08-1207, decided on the same day as the present case.[1]

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[1] Petitioners seek to distinguish the above "trademark subsidiary cases" by the fact that petitioners here allegedly "did not earn income through the in-state use of their intellectual or other property by a commonly-controlled affiliate." Pet. 25 n.7. The SJC stated that "[w]hile these cases are instructive with respect to their analysis of *Quill*, they are not directly on point factually." App. 21a. These decisions, however, some by the

Regarding out-of-state credit card companies such as the petitioners, the two state supreme court decisions on point agree. The SJC in this case cited the decision of the West Virginia Supreme Court in *MBNA Am. Bank*, 640 S.E.2d at 232-33, which held that (1) *Quill* was "grounded primarily on *stare decisis*, (2) the Court "appears to have expressly limited *Quill's* scope to sales and use taxes," and (3) "franchise and income taxes . . . do not appear to cause the same degree of compliance burdens." *Id.*; *see also MBNA Am. Bank, N.A. v. Ind. Dep't of State Revenue*, 895 N.E.2d 140 (Ind. Tax Ct. 2008) (citing West Virginia *MBNA Am. Bank* decision and rejecting requirement of physical presence).

Petitioners claim that "[o]ther state courts have reached the opposite conclusion," but they tell only part of the story. Pet. 22-25. These older decisions from state intermediate appellate courts[2]

States' highest courts, expressly support the proposition that economic *activity* of a certain nature and degree may create substantial nexus without a physical presence in the taxing State. The presence and use of trademarks in the taxing States in such cases merely illustrate *one* way in which transactions involving intangibles may result in substantial income flowing to a taxpayer from residents of a taxing State.

[2] United States Supreme Court Rule 10(b) generally limits the Court's consideration of a conflict of state decision to those by "the highest court of a state." *Id.* Thus, the Court "tries to achieve uniformity in federal matters only among the various courts whose decisions are otherwise final in the absence of Supreme Court review." R.L. Stern, *et al.*, *Supreme Court Practice* (9th ed.) 256 .

do not establish a conflict of authority that is worthy of review.

Only one of the three decisions cited by the petitioners strikes a State's franchise or income tax because of a lack of physical presence by the taxpayer in the taxing State. *See J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 840-41 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000). However, a later decision by the same intermediate appellate court cautions against too broad a reading of the decision in *J.C. Penney*. *America Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV, 2002 WL 1751434 at *2 (Tenn. Ct. App. July 30, 2002), declined to read *J.C. Penney* to "substitute 'physical presence' for 'nexus' as the first prong of the *Complete Auto Transit* test" in a challenge to a tax on an internet service provider. Petitioners claim that in *America Online* "Tennessee has not retreated from the holding in *J.C. Penney*," Pet. 22-23, but the implication of *America Online* is clear: *J.C. Penney* stands alone among the States and the decision has limited force even on its home field. *Cf. Wisniewski v. United States*, 353 U.S. 901, 902 (1957) ("It is primarily the task of [a lower court] to reconcile its internal difficulties.").

Nor does the 1993 decision of the Michigan Court of Appeals in *Guardian Industries Corp. v. Department of Treasury*, 499 N.W.2d 349 (Mich. App. 1993), demonstrate a significant split of state authority. *Guardian* did not strike down any tax, much less resolve the issue presented here. Rather, it involved the question whether certain taxpayers

with undeniable physical presence in Michigan could exclude from Michigan's "single business tax" certain of its "sales" of tangible personal property outside Michigan on the ground that they were taxable in other States. *Id.* at 352, 353. In the unusual posture in which the case arose, it was the taxpayers that urged that their nexus in other States was sufficient for taxation by those States. Conversely, the State of Michigan was urging that nexus was insufficient; and the taxing authorities in the other States were not involved in the case. One taxpayer stipulated that its activities in the non-Michigan States were limited to mere solicitation, and so was found not to be taxable there by the non-Michigan States. *Guardian* thus turned on whether the level of these activities forfeited the statutory immunity conferred by P.L. 86-272, 15 U.S.C. § 381, not whether they reached the threshold level of constitutional nexus. *Guardian* thus does not hold that a state income or franchise tax requires a physical presence; at most, it holds that in some circumstances a tax on a company whose in-state activities do not exceed the solicitation of sales of tangible goods may be foreclosed by a federal law limiting state taxation, such as P.L. 86-272. But that issue is not the same as that presented here. Finally, *Guardian* has little remaining force even in Michigan: the Michigan legislature has eliminated the tax at issue in *Guardian* and enacted a new tax that does not require a physical presence. MCL 208.1200(1).

Nor does the 2000 decision of the Texas Court of Appeals in *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000), establish a current

and significant conflict. In striking down the application of a state franchise tax, the Texas intermediate appellate court repeatedly stressed that the State had applied its franchise tax "solely" on the basis of the taxpayer's passive possession of a "certificate of authority" to do business in Texas. *Id.* at 298, 299, 300.[3] Despite broader *dicta*, therefore, *id.* at 300, *Rylander* does not strike an income or franchise tax where the taxing State actually relies on active and extensive transactions in intangible property with residents of that State.

In sum, the decisions of the state courts do not demonstrate "growing disagreement and confusion." Pet. 26. Nor do they reflect a conflict that is "substantial and mature." Pet. 25. They represent instead (1) a growing consensus among recent decisions and (2) minor historical anomalies from States that have joined or might later defer to the recent and clear trend. *Cf. Portland 76 Auto/Truck Plaza, Inc. v. Union Oil Co.*, 153 F.3d 938, 943 (9th Cir. 1998) ("Because of the importance of predictability to commercial relations, as well as

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3 Texas relied on the certificate of authority because it was state "*policy*" that "the licensing of intangibles, including patents, in Texas did not create franchise tax nexus." *Id.* at 302 (emphasis in original). Thus, Texas did not rely on the patent royalty payments that Bandag received from its Texas affiliate. The court indicated that the taxpayer's "sole activity" of relevance connecting it to Texas was "communication by United States mail and common carriers," without identifying any economic activity (except perhaps its licensing activities, which Texas did not count) that was the subject of such communication. Id. at 300.

deference to our sister circuits, we shall not lightly create an intercircuit conflict affecting commerce nationally."). For these reasons, the decisions cited by petitioners do not support plenary review of the issue presented at this time.

III. THE COURT SHOULD NOT GRANT REVIEW BASED ON MERE SPECULATION ABOUT BURDENS ON INTERSTATE AND FOREIGN COMMERCE.

A. Speculative Claims About an "Undue Burden" on Interstate Commerce Do Not Support Plenary Review of the Issue Presented.

Petitioners argue that the "question presented is critically important to interstate commerce." Pet. 26. They claim that "when a state abandons the physical presence requirement, it adversely affects interstate commerce by creating confusion and placing onerous burdens on multistate firms." *Id.* For the reasons stated below, these alleged burdens on interstate commerce do not justify plenary review in this case.

The SJC correctly rejected the same exaggerated predictions of doom by corporate net-income taxpayers and *amici curiae.* Contrasting the sales and use taxes addressed in *Quill*, the SJC stated that "an income-based excise . . . typically is paid only once a year (except when quarterly estimated taxes are required), to one taxing

jurisdiction on the state level, and the payment of such an excise does not entail collection obligations *vis-à-vis* consumers." App. 20a n.17 (citations omitted). The SJC continued:

> Determinations about whether the [petitioners] are subject to the FIET . . . or how to apportion income from business activity that is taxable within [Massachusetts] are the sorts of decisions that, more broadly, can confront all taxpayers, local or out-of-state, when calculating, reporting, and paying taxes on their income. While the making of these determinations is certainly more complex for large corporate taxpayers, it is part of the cost of doing business and is not, in our opinion, unduly burdensome on interstate commerce, particularly where such taxpayers, like the [petitioners] are earning substantial income from their business activities in Massachusetts and where the common usage of computer technology and specialized software has eased the administrative burdens of tax compliance.

Id.

Having failed to convince the SJC of an "undue burden" on commerce, petitioners and *amici curiae* now flood the Court with a new round of speculation about the impact of the nexus rule upheld in this case. But speculation does not establish clear proof that this case is of such "gravity and importance" as to warrant review by this Court. *See In Re Woods*, 143 U.S. 202, 206 (1892).

As the party urging a new rule of physical presence for corporate income taxes, petitioners have the burden to show an impact requiring intervention by this Court. Petitioners have not met their burden. They grossly exaggerate when they claim that the SJC decision has "major implications for every taxpayer whose activities cross state lines." Pet. 27. Such taxpayers selling tangible goods, if they have no physical presence in the taxing State, may be protected from tax by P.L. 86-272, 15 U.S.C. § 381. Petitioners similarly cite "small and medium size businesses," but these firms may be protected by (1) statutory thresholds protecting *de minimis* contacts, *see, e.g.,* Mass. Gen. Laws ch. 63, § 2A, or (2) the Due Process Clause. Petitioners also overstate the "enormous practical difficulties" in "ascertaining and satisfying their tax obligations" (Pet. 3): these alleged "burdens" may result merely from valid differences among the States in their methods of taxation.

Nor is plenary review supported by petitioners' citations to more recent state statutes and administrative actions declining to require a physical presence for the taxation of out-of-state firms doing business within a taxing State. *See* Pet. 30-33. Petitioners do not cite new litigation or practical problems arising from these developments, thus tending to prove that the approach is workable and not unduly burdensome. If issues later arise, they should be allowed to proceed through the state courts, where records could be developed to allow for full consideration of the alleged burdens of compliance. It is premature, however, to conclude

that recent state actions will produce a conflict of authority requiring intervention by this Court.

Finally, petitioners' claims about burdens on commerce ignore the other restraints imposed by the Commerce Clause, *viz.*, the requirements that any tax be fairly apportioned, non-discriminatory, and fairly related to a State's services. These other tests under *Complete Auto* address many specters conjured by petitioners and *amici curiae* in arguing for a physical presence requirement for nexus. The petition and the briefs of the *amici curiae* ignore the fact that issues regarding discrimination and multiple taxation are separate and distinct from nexus. These separate claims against state taxation do not support review of the nexus question presented in this case.[4]

B. The Alleged Impact on Foreign Commerce Was Not Raised Below and In Any Event Does Not Support Review by this Court.

Petitioners also argue that "state abandonment of the physical presence requirement threatens to disrupt the Nation's international tax policy." Pet. 29-30. Petitioners made no claim under the Foreign Commerce Clause in the SJC. *See Brief*

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[4] Petitioners argue that a "physical presence" rule is preferable to the rule applied by the SJC because the physical presence test alone is a "bright line" rule. But decisions of state courts demonstrate that the physical presence test has its own ambiguities. *See, e.g.*, *Dell Catalog Sales*, 199 P.3d 8863 (N.M. Ct. App. 2008), *cert. denied*, 129 S.Ct. 1616 (2009).

for Capital One Bank, Appellant, 2008 WL 4359871 (February 1, 2008). "In cases coming [to the Court] from state courts, there are reasons of peculiar force which should lead [the Court] to refrain from deciding questions not presented or decided in the highest court of the state . . . ." *McGoldrick v. Compagnie Generale*, 309 U.S. 430, 434 (1940). Even if petitioners have preserved the issue, or merely cite the alleged impact on foreign commerce as evidence of the importance of the question presented, their argument does not support plenary review. Such arguments by petitioners and *amici curiae* have not been documented or examined in these proceedings. If a foreign corporation later challenges a tax on such grounds, it may create a full record and seek review by this Court at that time. Meanwhile, as explained below, the policy arguments made by the petition should be addressed by Congress, not the Court.

IV. THE COURT SHOULD DENY THE PETITION IN DEFERENCE TO THE CONSTITUTIONAL ROLE OF CONGRESS IN WEIGHING BURDENS ON INTERSTATE COMMERCE.

Petitioners argue that "only a ruling from this Court can stop the flood of state efforts to impose unduly heavy burdens on interstate commerce." Pet. 26. To the contrary, the Court should deny the petition because the issue presented is better decided by Congress, which this Court has said has power under the Commerce Clause to "evaluate the burdens that taxes impose on interstate commerce."

Quill, 504 U.S. at 36. Whatever ruling that this Court might make on the merits of the issue presented here, "Congress remains free to disagree with [the Court's] conclusions." *Id.* Congress has enacted several limitations on state taxation. *See, e.g.*, 15 U.S.C. § 381; 15 U.S.C. § 391; 49 U.S.C. § 11501. It has specifically addressed the issue of state taxation of out-of-state banks, albeit in now-repealed acts.[5] Regarding the issue presented here, petitioners concede that Congress has for at least eight years considered bills directly addressing the issue. *See* Pet. 34 & n.14. Indeed, a bill addressing the issue is pending in the current session of Congress. *Id.*

Despite these legislative vehicles for action, petitioners insist that the Court must step in because "there is no realistic prospect that Congress will act on the issue in this case." Pet. 34. But this point ignores the most important inference from the fact of the bills: they show that the issue presented is by its nature one that Congress is "better qualified to resolve." *Quill*, 504 U.S. at 318 and n.11. Thus, in *Quill* the Court cited unenacted bills in its discussion of Congress's relative competence regarding the same issues. The Court recognized that Congress is "better qualified" to conduct a full study of the relevant factors, including alleged burdens on business and likely fiscal impacts on the States. These issues are ones involving legislative

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[5] *See* 2008 WL 4359874 *26-36 (*Brief Amicus Curiae of Multistate Tax Comm'n* in *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76 (2009)).

fact. They are better weighed by Congress in hearings, reports, and debates. *See, e.g.*, *Interstate Taxation Act: Hearings on H.R. 11798 and Companion Bills Before Special Subcomm. On State Taxation of Interstate Commerce of the House Comm. on the Judiciary*, 89th Cong., 2d Sess. (1966). Where, as here, taxpayers seek a broad exemption from tax, Congress is better qualified to judge the impact of the exemption on other commerce and other types of state taxation.

Petitioners and several *amici curiae* argue that new technologies will expand the types of interstate commerce that does not require a "physical presence" in a State in order to earn millions of dollars doing business there. Petitioners are surely right in this prediction. But the very facts that they cite as proof of an "unconstitutional" burden on commerce are by their nature legislative facts that Congress is institutionally well qualified to weigh. Judicial review of the same questions, in contrast, is necessarily limited by the four-corners of a judicial record and the retrospective cast of a lawsuit. Judicial conclusions about respective burdens will necessarily be both limited and speculative. The Court has warned that the judiciary "must be on guard against imprisoning the taxing power of the states within formulas that are not compelled by the Constitution but merely represent judicial generalizations exceeding the concrete circumstances which they profess to summarize." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445 (1940). For these reasons, the Court should

defer to the legislative role expressly conferred on Congress by the Commerce Clause.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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80

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No. 08-1169

IN THE

Supreme Court of the United States

CAPITAL ONE BANK (USA), N.A.,
F/K/A CAPITAL ONE BANK, AND CAPITAL ONE, N.A.,
AS SUCCESSOR TO CAPITAL ONE F.S.B.,

Petitioners,

v.

COMMISSIONER OF REVENUE OF MASSACHUSETTS,

Respondent.

**On Petition For A Writ Of Certiorari
To The Supreme Judicial Court Of Massachusetts**

REPLY BRIEF FOR THE PETITIONERS

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

CASES

OTHER AUTHORITIES

REPLY BRIEF FOR THE PETITIONERS

Respondent does not even attempt to rebut petitioners' compelling showing that the decision of the Supreme Judicial Court ("SJC") is utterly irreconcilable with the rationale of *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992), which construed the same "substantial nexus" prong that governs this case. Essentially conceding that no principled ground for distinction exists, respondent merely reiterates the SJC's *ipse dixit* that *Quill* should be limited to its facts, even though this Court has repeatedly cited *Quill* outside the use-tax context. This Court's precedents ought not be so lightly dismissed by lower courts. The SJC's cavalier treatment of *Quill* deserves further review.

Respondent also overlooks the inconsistencies between the judgment below and this Court's other Commerce Clause precedents, and fails to rebut petitioners' showing that the SJC's ruling exacerbates a growing conflict among decisions of multiple state appellate courts. Furthermore, by authorizing an amorphous "economic-nexus" pseudo-test for taxation of non-domiciliaries, the decision below contributes to the growing uncertainty over such taxation, which only this Court is realistically in a position to resolve.

Respondent strives mightily to deny the extraordinary importance of the question presented, but her arguments ring hollow, particularly given the broad array of amicus voices clamoring for review in this case. Most tellingly, respondent offers no response whatsoever to the States' amicus brief urging this Court to grant certiorari and provide

much-needed clarity and timely guidance in this crucial area of the law. The time has come to confirm, as *Quill's* logic dictates, that "substantial nexus" requires physical presence as a bright-line, irreducible minimum.

A. The Decision Below Is Irreconcilable With *Quill* And Other Precedents Of This Court

1. Respondent first attempts to minimize the importance of *Quill*. Echoing the SJC's errors, she dismisses that controlling precedent as applicable only to "sales and use taxation and the mail-order industry" (Opp. 12), and as resting entirely on the *stare decisis* effect of *National Bellas Hess, Inc.* v. *Department of Revenue of Illinois*, 386 U.S. 753 (1967). Both arguments lack merit.

First, although the facts examined in *Quill* concerned use taxation of mail-order catalogue transactions, this Court based its decision on an interpretation of the Commerce Clause's substantial-nexus requirement, not on constitutional principles somehow unique to mail-order merchandising. As demonstrated (Pet. 11-12), this Court has freely cited *Bellas Hess* and *Quill* in cases outside the sales-and-use-tax context. Those cases endure, yet respondent fails to discuss any of them. Contrary to respondent's implausible theory, *Quill* established no unprincipled, formalistic wall dividing sales and use taxation from income taxation for constitutional purposes. The SJC boldly overstepped its authority in arbitrarily confining this Court's precedents to the particular taxes at issue in those cases.

Respondent's insistence that the physical-presence requirement applies solely to the precise tax addressed in *Quill* also disinters the very formalism this Court laid to rest in favor of examining the

"practical effect" of state taxes under the Commerce Clause. *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977); Pet. 17-18. Respondent does not even dispute, much less cure, this further weakness in her position.

Second, respondent is mistaken in arguing that the discussion of *stare decisis* in *Quill* supports limiting the decision to the sales-and-use-tax context. That discussion was necessary to demonstrate that the North Dakota Supreme Court had erred in setting aside *Bellas Hess* as obsolete. Pet. 4-5. But the *Quill* Court did not stop there, as respondent would have it. Instead, the Court went on to hold that the physical-presence requirement is entirely consistent with, and is indeed an interpretation of, the substantial-nexus requirement (504 U.S. at 311)—a requirement that applies equally in this case, which involves essentially identical nexus-related facts.

Respondent's improbable contention is that the logic of *Quill* should be ignored because *Quill* relied in part on *stare decisis*. That argument is not only inherently nonsensical but also incomplete. Even before this Court decided *Bellas Hess*, it applied the physical-presence rule outside the narrow sales-and-use-tax context to a tax analogous to the one challenged here. *Norton Co.* v. *Dep't of Revenue of Ill.*, 340 U.S. 534 (1951); Pet. 12-13.

Respondent fails even to cite (much less distinguish) *Norton*, but that ostrich-like tactic merely reveals the weakness of respondent's position. Thus, contrary to respondent's contention that petitioners are "urging a new rule of physical presence" (Opp. 23), *Norton* confirms that physical presence has long been the constitutional precondition for state taxation of non-domiciliaries, including taxes based on

the taxpayer's gross receipts (*i.e.*, income). Indeed, this Court has ***never*** upheld a state income tax where physical presence was lacking. The growing rebellion by state courts dissatisfied with this Court's validation of the physical-presence requirement should not escape review.[1]

2. Respondent also confuses the Commerce Clause and the Due Process Clause as distinct limitations on state taxing powers. As explained (Pet. 19-20), the SJC effectively collapsed the Commerce Clause's substantial-nexus requirement into the far less demanding "minimum contacts" test under the Due Process Clause, thereby contravening *Quill*'s clear holding that the Commerce Clause test is more rigorous and requires a closer nexus. 504 U.S. at 313. Respondent offers no defense of the SJC's analysis, and suggests no means for keeping the inquiries under the two clauses separate, as *Quill* demands.

Indeed, respondent ardently embraces the SJC's error when she asserts—without citing any authority (Opp. 23)—that small and medium-sized businesses should look to the Due Process Clause, rather than the Commerce Clause, to protect them from the burdens imposed by the uncertainties of state taxation under the economic-nexus theory. *Cf.* Council on State Taxation ("COST") Br. 16-17 (describing spe-

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1 Respondent states that petitioners' marketing efforts aimed at Massachusetts consumers included "solicit[ing] credit card customers through . . . third parties at marketing events and at retail establishments" (Opp. 7), but the record is clear that, as the SJC found, petitioners "neither owned nor leased any real property" in Massachusetts, they "owned no other Massachusetts property, and no employee, agent, or independent contractor" of petitioners "was located in Massachusetts." App. 3a.

cial burdens on small businesses). In so doing, respondent effectively concedes that the SJC has eviscerated the Commerce Clause's substantial-nexus requirement as an independent safeguard against illegitimate state taxation, instead restoring a regime under which only the Due Process Clause constrains such taxation. *Quill* definitively rejects that approach.

B. The Decision Below Deepens A Concrete And Persistent Conflict

1. Respondent errs in dismissing the division among state appellate courts over the question presented. Opp. 14-15. Multiple state courts have addressed this recurring issue. Pet. 21-25; Virginia ("States") Br. 3-7. Because it hinges entirely on the proper interpretation of this Court's own precedents, however, additional percolation in the state courts will not provide enlightenment.

Furthermore, the conflict cannot be disregarded as "well past its shelf life." Opp. 15. As the amicus States correctly observe in urging certiorari, the continuing split of authority "invites complex litigation and creates uncertainty" for state tax systems. States Br. 2. Review is essential now to avoid exacerbating those and other serious problems that the conflict has already spawned. Pet. 26-33.

2. Denying that the state courts are in disarray, respondent relies heavily (Opp. 15-16) on cases that involve very different nexus-related facts and are thus inapposite, as even the SJC recognized. Pet. 25 n.7. The courts in the intangible-holding-company cases rejected Commerce Clause challenges to state taxation of "foreign corporations with intangible property . . . that was being used in the taxing State by a licensee" physically present in the State (App.

21a n.19), where the licensees and the foreign corporations typically were commonly controlled. *See, e.g.*, *A&F Trademark, Inc.* v. *Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004) (taxpayer "licenses trademarks to a related retail company operating stores located within" taxing State).

The Commerce Clause gives States various avenues for taxing inter-company transfers attributable to members of a commonly-controlled group of corporations, one of which does business in-state. *See, e.g.*, *Comptroller of the Treasury v. SYL, Inc.*, 825 A.2d 399, 415 (Md. 2003) (concluding that intangible holding companies "had no real economic substance as separate business entities" for tax purposes). The question of state authority to tax intangible-holding-company royalties is thus far removed from the issue here. Unlike in those cases, there is no suggestion that petitioners derive income from commonly-controlled corporations with a physical presence in Massachusetts. All of petitioners' physical conduct supporting their business transactions with Massachusetts residents occurred outside of Massachusetts. The apparent agreement among state courts over intangible-holding-company cases thus sheds no light here.[2]

Respondent also errs in relying (Opp. 16) on irrelevant cases involving taxpayers physically present within the taxing State. *See Gen. Motors Corp.* v. *City of Seattle*, 25 P.3d 1022, 1024 (Wash. Ct. App. 2001) (taxpayer had physical presence based on regu-

[2] Notwithstanding respondent's suggestion (Opp. 6-7), the SJC did not rely on the appearance of the "Capital One" trademark on credit cards as a purported basis for the assertion of taxing authority, and there is no suggestion that petitioners earned royalties from any in-state licensee of the trademark.

lar visits by its agents); *Borden Chems. & Plastics* v. *Zehnder*, 726 N.E.2d 73, 81-82 (Ill. App. Ct. 2000) (partnership's in-state presence imputed to taxpayer-partner); *Couchot* v. *State Lottery Comm'n*, 659 N.E.2d 1225, 1230-31 (Ohio 1996) (taxpayer purchased lottery ticket in state); *see also Buehner Block Co.* v. *Wyo. Dep't of Revenue*, 139 P.3d 1150, 1152 (Wyo. 2006) (taxpayer failed to collect sales tax on product delivered to in-state customers).

3. Respondent also attempts to downplay the depth of the state appellate conflict by painting the three key precedents as inapposite or superseded. Opp. 18-20. As the brief of Virginia and South Dakota confirms, however, those cases establish a concrete conflict that continues to generate uncertainty for States and taxpayers alike. States Br. 6-7.

After conceding that the decision below conflicts with *J.C. Penney National Bank* v. *Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), respondent rehashes the SJC's excuse for ignoring that case (Opp. 18), contending that the decision was abrogated by the unpublished decision in *America Online, Inc.* v. *Johnson*, No. M2001-00927COA-R3-CV, 2002 WL 1751434 at *2 (Tenn. Ct. App. July 30, 2002) ("*AOL*"). As explained (Pet. 23 n.5), *AOL* held only that a determination of whether the taxpayer had in-state physical presence required additional factfinding, and in Tennessee (as elsewhere), unpublished dispositions cannot overrule published precedents. Respondent offers nothing in rebuttal. *J.C. Penney* thus stands as binding statewide precedent in Tennessee. Pet. 22-23.

Respondent also misreads *Guardian Industries Corp.* v. *Department of Treasury*, 499 N.W.2d 349 (Mich. Ct. App. 1993). Opp. 18-19. There the court

remanded for factfinding to determine whether the taxpayer had physical presence (through its employees' sales activities) in numerous States to which the taxpayer had made tax payments that it sought to credit against its Michigan tax obligations. 499 N.W.2d at 357. The court held that if the taxpayer's "employees were never present" within those States (*id.*), the taxpayer would not be entitled to a credit because those States could not validly tax the taxpayer's activities—a clear application of the very physical-presence rule that the SJC rejected. Although Michigan rewrote its tax laws after *Guardian* was decided (Pet. 32), nothing indicates that the Michigan courts have abandoned the physical-presence rule that was clearly adopted and enforced in *Guardian*.

Respondent fares no better in her effort (Opp. 19-20) to distinguish *Rylander* v. *Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000). To be sure, the State there sought to tax the taxpayer's state-derived income based on its possession of a certificate to do business within the State. 18 S.W.3d at 299. The crucial point, however, is that in deciding whether the State's assertion of taxing authority was consistent with the Commerce Clause, the court squarely held that in-state physical presence is a precondition for imposition of taxes such as the franchise tax in question. *Id.* at 299-300; *see* Pet. 23-24. The Commerce Clause "substantial nexus" analysis that respondent dismisses as dicta was thus a critical step in the *Rylander* court's reasoning, and that reasoning is directly contrary to the decision below.

C. The Existing And Increasingly Burdensome Uncertainty Over The Question Presented Intensifies The Need For Review

1. Respondent discounts as mere "speculation" the unconstitutional burdens on interstate commerce created by the vague economic-nexus approach and the continuing uncertainty over the scope of the physical-presence requirement. Opp. 21-25. Yet state taxation in defiance of *Quill* threatens "insurers, online retailers, software makers, and other companies that mainly operate in a single state but have customers across the U.S." Jessica Silver-Greenberg, *Corporate Taxes Cross State Lines*, BUSINESSWEEK, June 1, 2009, at 28. Amici provide authoritative accounts of the reality and extent of those harms, belying respondent's breezy assurances that review is not warranted. As amici demonstrate, broad segments of the business community are suffering in ever-increasing measure from the confusion surrounding this issue and from the burdens of state taxation under the economic-nexus theory. COST Br. 6-19; Clearing House Ass'n ("CHA") Br. 9-11; Tax Executives Institute ("TEI") Br. 6-13.

Moreover, even apart from the impact upon *taxpayers*, the submission of Virginia and South Dakota demonstrates that *taxing States* recognize the uncertainty swirling around the question presented and the urgent need to resolve it. States Br. 3-13. It is unsurprising that respondent—having prevailed in the highest forum (other than this Court) with jurisdiction to address the constitutionality of Massachusetts' tax—now seeks to avoid review. But that self-interested preference ought not prevail over the earnest plea of other States for this Court's intervention to settle the controversy for the entire Nation.

2. In contending that income taxes must be distinguished under the Commerce Clause from sales and use taxes, respondent parrots the SJC's unsubstantiated musings about the comparative compliance burdens that purportedly make the latter more onerous than the former. Opp. 21-22. As explained (Pet. 13-16), however, this Court has already addressed that question, and has concluded that income taxes are *more* burdensome than sales and use taxes. A use tax often is not a significant obligation, this Court stated, because the "burden of the tax is placed on the ultimate purchaser," such that the out-of-state vendor itself "is charged with no tax" (*Scripto, Inc.* v. *Carson*, 362 U.S. 207, 211 (1960)), which makes the "case for the validity of the imposition" of use taxes "stronger" than the case for imposition of "fairly apportioned, non-discriminatory direct taxes" (*Nat'l Geographic Soc'y* v. *Cal. Bd. of Equalization*, 430 U.S. 551, 557-58 (1977)). In addition, when more than one State imposes a tax on a corporation's income, the serious "risk of double taxation" that arises has no counterpart in the sales-and-use-tax context. *Id.*

The SJC's refusal to heed those conclusions heightens the conflict between its reasoning and this Court's prior decisions. The difference in burdens, moreover, has not diminished since this Court last considered them: Income taxes remain far more burdensome than sales and use taxes, imposing direct liability (rather than mere collection responsibility) and requiring multiple filings each year (typically including quarterly estimated taxes as well as annual returns) that are subject to a vast array of often-differing rules regarding reporting method, apportionment, computation of tax base and deduc-

tions, depreciation, etc. COST Br. 8-16; TEI Br. 14-16.

3. Respondent also contends (Opp. 24) that the burdens identified by petitioners and their amici should not be relieved through enforcement of the substantial-nexus requirement, but rather through the non-discrimination and fair-apportionment requirements. *See Complete Auto*, 430 U.S. at 279. This Court made explicit in *Quill*, however, that the substantial-nexus requirement serves an independent function as "a means for limiting state burdens on interstate commerce." 504 U.S. at 313. The elements of the *Complete Auto* test cannot be used to undermine each other. Respondent's approach must be rejected, as it would promote double taxation while rendering the substantial-nexus requirement effectively superfluous.

4. Respondent invokes the waiver doctrine (Opp. 24-25) to answer the argument that the economic-nexus approach may have significant and disruptive ramifications for foreign relations. Pet. 29-30; *see* CHA Br. 14-21. Respondent misses the point. The crucial concern—essentially unrebutted by respondent—is that the substantial-nexus approach adopted by the SJC threatens to undermine this Nation's preferred approach to international taxation by encouraging reciprocal violations of the "permanent establishment" principle. Review by this Court is therefore warranted, because reaffirmation of the physical-presence requirement will alleviate the foreign-relations concern by clarifying the constitutional prohibition against state efforts to pursue non-domiciliary foreign businesses.

5. Finally, respondent advocates denial of review on the theory that Congress is "better qualified" to

address whether physical presence is a precondition for state taxation of non-domiciliaries' income. Opp. 25-27. Congressional competence, however, is not at issue.

The SJC's holding rests on a misreading of this Court's constitutional decision in *Quill*, which affirmed the Commerce Clause component of *Bellas Hess* and thus interpreted the Constitution itself. 504 U.S. at 314. Accordingly, the decision below reflects an error in constitutional interpretation, not the mere adoption of unsound policy suited for legislative alteration. This Court's review is necessary to restore the "bright-line rule" of *Quill* (504 U.S. at 317), a rule that some state courts (like the SJC) have eroded since *Quill* was decided. It is well within this Court's competence to secure obedience to its own precedents.

Congress has shown no inclination to take up the constitutional issue presented in this case. Pet. 33-34 & n.14; *see* TEI Br. 12-13 & n.8 (observing that Congress has never voted on "the nexus related portions" of any post-*Quill* bills "that would have legislated the limits of state tax nexus"). The mere possibility of congressional action did not foreclose review in *Quill* (*see* 504 U.S. at 318 & n.11), and should not do so here. It is time for this Court to eliminate the intolerable uncertainty created by the willingness of some state courts to pronounce *Quill* a dead letter in this context.

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For the foregoing reasons, and those stated in the petition, certiorari should be granted.

Respectfully submitted.

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CAPITAL ONE BANK (USA), N.A.,
F/K/A CAPITAL ONE BANK, and CAPITAL ONE, N.A.,
AS SUCCESSOR TO CAPITAL ONE F.S.B.,

Petitioners,

—v.—

COMMISSIONER OF REVENUE OF MASSACHUSETTS,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE SUPREME JUDICIAL COURT OF MASSACHUSETTS

BRIEF OF THE CLEARING HOUSE ASSOCIATION, THE NATIONAL FOREIGN TRADE COUNCIL, THE ORGANIZATION FOR INTERNATIONAL INVESTMENT, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, AND THE UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

Cases

Statutes

Books, Treatises, Journals, and Other Sources

Pursuant to Rule 37.2 of the Rules of this Court, The Clearing House Association L.L.C. ("The Clearing House"), the National Foreign Trade Council ("NFTC"), the Organization for International Investment ("OFII"), the Securities Industry and Financial Markets Association ("SIFMA"), and the United States Council for International Business ("USCIB") (collectively, "amici") respectfully submit this brief amicus curiae in support of the petition of Capital One Bank (USA), N.A., fka Capital One, N.A., as successor to Capital One F.S.B. ("Capital One"), with the consent of all parties.[1]

INTEREST OF THE AMICI CURIAE

All amici are organizations concerned with the continued vitality of the U.S. economy, employment and international trade, and with the competitiveness of U.S. businesses both at home and abroad.[2] The Clearing House is an association of ten leading commercial banks.[3] The Clearing House regularly appears as amicus curiae in cases raising important issues relating to banking, and its

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[1] Both parties have consented to the submission of this brief. Counsel of record for all parties received notice at least 10 days prior to the due date of the amici's intention to file this brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than amici, their members, or their counsel made a monetary contribution to the preparation or submission.

[2] For a description of each amici, see Appendix A hereto.

[3] The members of the Clearing House Association are ABN AMRO Bank, N.V.; Bank of America, N.A.; The Bank of New York Mellon; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA; JPMorgan Chase Bank, N.A.; UBS AG; U.S. Bank, N.A.; and Wells Fargo Bank, N.A.

members — along with those of the other amici — have a common and vital interest in the proper and consistent application of the nexus standards for state taxation in this country.

In addition to sharing concerns raised in Capital One's petition related to the inappropriate and imposition of state income or excise taxes, amici are concerned that a state's imposition of income and excise taxes on a corporation with no physical presence in that state threatens to damage U.S. international economic relations. In particular, amici believe that the decision below is likely to embolden aggressive extraterritorial taxation by both states and foreign nations; such actions by states will damage commercial comity between the U.S. and other nations, and such actions by foreign nations will result in the U.S. collecting less tax revenues (after foreign tax credits) from U.S.-based activities of U.S. residents and corporations. Amici believe that the question presented in the petition for certiorari in this case requires resolution by this Court to avoid these serious consequences.

SUMMARY OF ARGUMENT

The decision below[4] represents a broad and unwarranted exercise of state taxing jurisdiction and

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[4] *Capital One Bank* v. *Comm'r of Revenue*, 899 N.E.2d 76 (Mass. 2009), Petitioner's Appendix ("Pet. App.") at 1a-22a.

should be reversed because it carries serious implications for U.S. taxing jurisdiction vis-à-vis foreign authorities. The decision upheld Massachusetts' imposition of income-based excise taxes on Capital One despite Capital One's total physical absence from the state of Massachusetts — not an office, not a branch, not even a mailbox.

The decision below employs an "economic nexus" standard that violates the Commerce Clause of the U.S. Constitution and nearly universally accepted international norms requiring a physical presence (in the form of a "permanent establishment") as a predicate for income-based taxation. Indeed, the decision below openly disregards this Court's Commerce Clause decisions on the premise that this Court will overrule its precedents. If states are allowed to tax the income of citizens and corporations of other states or nations based on this nebulous economic nexus standard, the delicate balance carefully established by numerous international tax treaties will be upset, causing serious disruption to the expectations of international businesses that engage in commerce with U.S. persons.[5]

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[5] *See Quill Corp.* v. *North Dakota*, 504 U.S. 298, 317 (1992) (noting substantial reliance interest existing in the physical presence rule).

Moreover, a serious violation of international norms of the sort undertaken by Massachusetts here undermines the position that the U.S. has long embraced in tax treaty negotiations with foreign nations. Permitting such an unwarranted exercise of extraterritorial jurisdiction by one state is likely to invite reciprocal tactics by foreign taxing authorities, seriously compromising the U.S. economy, investments and employment in the U.S. and the competitive leadership of U.S. businesses. Ultimately, under the foreign tax credit system that has long been a cornerstone of our income tax system,[6] this would have the effect of surrendering to other nations taxing jurisdiction over activities of U.S. corporations which have no physical presence abroad and thereby reducing U.S. tax revenues.

ARGUMENT

I. Economic Nexus (as Opposed to Physical Presence) as a Basis for Extraterritorial Taxation Conflicts with International Tax Policy

The court below permitted the imposition of income-based excise taxes on Capital One based on an economic nexus standard and openly acknowledged that Capital One need not have any

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[6] *See* 26 U.S.C. §§ 901-908 (2008); *see also* 26 U.S.C. § 164(a)(3).

physical presence in Massachusetts.[7] Not only does such an economic nexus standard fly in the face of this Court's Commerce Clause precedents, it is diametrically contrary to the international consensus that is reflected in an intricate network of tax treaties.

A. International Tax Policy is Found in the Extensive Network of Bilateral Tax Treaties Binding Nations Throughout the World

Income tax treaties are bilateral agreements composed of a set of mutual adjustments and concessions between the treasuries of the treaty countries.[8] Although the first income tax treaty was signed at the turn of the 20th century, income tax treaties only became widespread after World War I when the war-torn governments of Europe imposed high income tax rates to finance their war efforts and reconstruction.[9] The treaties were designed to eliminate double taxation by allocating the tax base between countries in an equitable manner and, in doing so, promoting international trade and

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[7] *See* 899 N.E.2d at 78 n.5, Pet. App. 3a (noting the lower court's statement that no physical presence in Massachusetts was required).

[8] *See* Joseph Isenbergh, International Taxation: U.S. Taxation of Foreign Persons and Foreign Income (4th ed. 2006), § 101:1.

[9] *See* Zvi D. Altman, Dispute Resolution Under Tax Treaties 196 (International Bureau of Fiscal Documentation) (2005).

investment.[10] Physical presence had been the time-tested standard for establishing tax nexus. Consequently, these treaties adopted this standard as their own. With the globalization and integration of the nations' economies, taxation has become an increasingly international endeavor, further underscoring the importance of tax treaties to international trade.[11]

Among the network of treaties that developed, a universal requirement for imposing income taxes on a nonresident is physical presence in the taxing jurisdiction sufficient to constitute a "permanent establishment" (or "PE"), as that term is defined in those treaties.[12] Under these treaties, if there is a PE, the taxing jurisdiction may then tax the portion of the nonresident's income attributable to the PE, but only that portion.[13]

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[10] *See* Joel Slemrod, *Free Trade Taxation and Protectionist Taxation*, 2 Int'l Tax & Pub. Fin. 471, 479 (1995); *see also* Richard E. Andersen, *Analysis of United States Income Tax Treaties*, § 1.01, Warren, Gorham & Lamont of RIA (2009), *available at* ITTUS WGL 1.01.

[11] *See id.*

[12] *See* Isenbergh, *supra* note 8, at § 103:9; *see, e.g.*, Appendices B and C hereto (citing numerous tax treaties requiring a PE, including all tax treaties to which the U.S. is a party).

[13] Isenbergh, *supra* note 8, at § 103:9. A typical statement of this rule is as follows:

The United States currently is a party to 58 bilateral tax treaties covering 66 countries.[14] Each and every one of these treaties requires a PE before a foreign nation may impose tax on the business income of a U.S. resident[15] (and, reciprocally, prevents the U.S. from imposing a tax on the business income of a resident of the treaty counterparty absent a PE in the United States). All of the

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> The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as are attributable to that permanent establishment.

U.S. Model Treaty United States Model Income Tax Convention of November 15, 2006 (hereinafter "U.S. Model Treaty"), art. 5.

[14] *See* Testimony of Michael F. Mundaca, then-Deputy Assistant Secretary for International Tax Affairs, U.S. Department of the Treasury (current Acting Assistant Secretary (Tax Policy)), Before the Senate Committee on Foreign Relations on Pending Income Tax Treaties, at 5 (July 10, 2008), *available at* 2008 TNT 134-29 (2008). Because one of these 58 treaties covers multiple countries — in particular, the successor countries to the former U.S.S.R. — there are 66 countries involved.

[15] *See* Appendix B hereto.

tax treaties among the G8 nations,[16] India and China — economies that collectively represent over 60% of the worldwide GDP[17] — require a PE.[18] Worldwide, there are over 2,500 bilateral tax treaties in force.[19] "With different shadings in different treaties, some form of [the PE] principle is universal."[20]

This universal practice is also incorporated in model tax treaties that embody international norms. Like all the prior U.S. model treaties, the current U.S. Model Treaty, released in November 2006 and used by the U.S. as the basis for its treaty negotiations, includes the standard PE rule.[21] Additionally, the United Nations, as well as the

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[16] As a premier international forum for policy research and discussion, the G8 counts among its member nations Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States. *See* G8 Summit 2009, *available at* http://www.g8italia2009.it/G8/Home/G8-G8_Layout_locale-1199882116809_FAQ.htm#ancora1.

[17] *See* The Central Intelligence Agency, World Fact Book, Country Comparisons — GDP (2008), *available at* https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html

[18] *See* Appendix C hereto (citing all tax treaties among the G8 Nations, plus India and China, all of which contain a PE requirement).

[19] *See* Eduardo Baistrocchi, *The Transfer Pricing Problem: A Global Proposal for Simplification*, 59 Tax Law 941 (2006).

[20] Isenbergh, *supra* note 8, at § 103:1.

[21] U.S. Model Treaty, *supra* note 13, art. 5, art. 7, para. 1.

Organization for Economic Cooperation and Development (the "OECD")[22] — an organization that regularly serves as the premier international forum for reform efforts in a number of policy areas, including international taxation[23] — have similarly developed model treaties for purposes of assisting nations in negotiating tax treaties.[24] Both the U.N. and OECD model treaties contain the PE rule.[25]

Moreover, an OECD working group concluded (over objections voiced by a few countries, discussed

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[22] The OECD is a Paris-based organization composed of 30 industrialized countries — representing a significant majority of the world economy — "sharing a commitment to democratic government and market economy" through such efforts as coordination of "domestic and international policies to help members and non-members deal with an increasingly globalised world." OECD, What is the OECD?, *available at* http://www.oecd.org/document/11/0,3343,en_2649_34487_2482699_1_1_1_1,00.html.

[23] *See* Arthur J. Cockfield, *The Rise of OECD as Informal 'World Tax Organization' Through the Shaping of National Responses to E-Commerce Tax Challenges*, 8 Yale J.L. & Tech. 136 (2006).

[24] *See* United Nations Model Double Taxation Convention Between Developed and Developing Countries (2001) (hereinafter "U.N. Model Convention"); OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital (Paris, OECD 2008) (hereinafter "OECD Model Treaty").

[25] *See* U.N. Model Convention, *supra* note 24, art. 5; OECD Model Treaty, *supra* note 24, art. 5.

below) that the consistent inclusion of the PE requirement in the world's intricate web of tax treaties serves the important goals of economic predictability and uniformity in international trade, mitigating double taxation and preventing tax jurisdictional disputes while reducing considerable administrative burdens.[26] As a then-Treasury Department official testified in 2003 before a committee of the U.S. Senate, "[t]he success of this framework is evidenced by the fact that the millions of cross-border transactions that take place around the world each year give rise to relatively few disputes regarding the allocation of tax revenues between governments."[27] While this multilateral approach to tax nexus is well-established and

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[26] *See* Michael F. Mundaca, *How Much Should Borders Matter?: Tax Jurisdiction in the New Economy*, Testimony of Michael F. Mundaca, former Treasury Department official, then-Principal at Ernst & Young, current Acting Assistant Secretary (Tax Policy), U.S. Department of the Treasury, Before the Senate Committee on Finance, Subcommittee on International Trade, at 7 (July 25, 2006), *available at* www.senate.gov/~finance/hearings/testimony/2005test/072506mmtest.pdf (testifying about the OECD working group report).

[27] Testimony of Barbara Angus, International Tax Counsel, United States Department of the Treasury, Before the Senate Committee on Foreign Relations on Pending Income Tax Agreements, at 1 (March 5, 2003), *available at* 2003 TNT 45-19.

beneficial to all nations, the balance is delicate and not immune from disruption.

B. A PE Exists Only Where There is Physical Presence

All treaties including a PE requirement define a PE as a "fixed place of business," and most use the following more detailed definition:

> 1. [T]he term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
>
> 2. The term "permanent establishment" includes especially:
>
> a) a place of management;
> b) a branch;
> c) an office;
> d) a factory;
> e) a workshop; and
> f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.[28]

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[28] *See, e.g.*, U.S. Model Treaty, *supra* note 13, art. 5; OECD Model Treaty, *supra* note 24, art. 5; U.N. Model Convention, *supra* note 24, art. 5.

It is clear that a PE cannot exist without a physical presence in the jurisdiction, and that such presence must have some duration and permanence. The PE requirement protects U.S. corporations with customers — but no physical presence — abroad from overseas taxation. Reciprocally, the PE requirement (and various portions of the U.S. Internal Revenue Code) protect a non-U.S. company from U.S. taxation absent a physical presence in this country.

Despite slight variations in the definition of PE from treaty to treaty, one constant is the requirement of meaningful *physical* connection between the taxing jurisdiction and the taxpayer.[29] The Technical Explanation to the U.S. Model Treaty refers to the commentary in the OECD Model Treaty and explains that "a general principle . . . in determining whether a permanent establishment exists is that the place of business must be 'fixed' in the sense that a particular building or physical location is used by the enterprise for the conduct of its business . . . ."[30] The OECD Commentary uses similar language.[31]

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[29] Isenbergh, *supra* note 8, at § 103:11.
[30] Technical Explanation Accompanying the United States Model Income Tax Convention of Nov. 15, 2006, art. 5, ¶ 1.
[31] OECD Commentary to Article 5, ¶¶ 4-8. The OECD Commentary now also contains an alternative, less demanding,

Not only is physical presence the universally accepted standard for defining tax nexus, it is also the law of this nation under the Commerce Clause of the U.S. Constitution. As discussed in the petition for certiorari in this case,[32] this Court expressly endorsed the rule requiring physical presence in *National Bellas Hess, Inc.* v. *Dep't of Revenue of Illinois,*[33] and affirmed its continuing vitality twenty-five years later in *Quill Corp.* v. *North Dakota.*[34] Indeed, *Quill* itself summarized this Court's prior cases upholding state taxation as all "involv[ing] taxpayers who had a *physical presence* in the taxing State."[35] The concerns and interests that undergird the physical presence standard in this Court's Commerce Clause jurisprudence — the need to foster "settled expectations"[36] and to rescue taxpayers from the "welter of complicated obligations"[37] — are also

PE clause providing the potential for tax nexus over a service provider which is physically present in the taxing jurisdiction for at least 183 days out of any twelve month period. *Id.* ¶ 42.23. Even this crack in the wall of the PE provision merely loosens the *permanence* of the requisite physical presence, not the need for physical presence.

[32] *See* Pet. at 3-5.

[33] 386 U.S. 753 (1967).

[34] 504 U.S. 298 (1992).

[35] *Id.* (emphasis added).

[36] *Id.* at 314-16.

[37] *Bellas Hess*, 386 U.S. at 759-60.

the same concerns and interests that led to its adoption as the norm in the international community.[38]

C. The Lower Court's Departure from a Settled Norm of Physical Presence Will Encourage Aggressive Extraterritorial Tax Measures

The decision below imposed direct taxes on Capital One despite acknowledging Capital One's physical absence from that state. If the decision below stands, other U.S. states will be emboldened to extend their already-aggressive efforts to impose extraterritorial taxes.

Massachusetts is by no means the only state to impose taxes of the sort at issue in this case. Other examples abound, at least eight of which are discussed in the petition for certiorari in this case.[39]

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[38] *See, e.g.*, OECD Technical Advisory Group, Final Report, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?*, (2006), *available at* http://www.oecd.org/dataoecd/58/53/35869032.pdf; Isenbergh, *supra* note 8, at § 103:2.

[39] *See* Pet. at 21-22, 31-33. *See also* N.Y. Tax Law § 1451(c)(1) (2008) (employing economic nexus to tax out-of-state banks which have issued credit cards to persons residing in New York); OHIO REV. CODE ANN. § 5751.02 (2008) (Ohio's Commercial Activity Tax); N.J. STAT. ANN. § 54:10A (2008) (New Jersey's Corporation Business Tax); *Kmart Props., Inc.* v. *Taxation and Revenue Dep't*, 131 P.3d 27 (N.M. App. 2001); *A&F Trademark Inc.* v. *Tolson*, 605 S.E.2d 187 (N.C. App.

While it is understandable that states must raise revenues and balance their budgets, extraterritorial taxation of those without a physical presence in the taxing state is the wrong approach to accomplishing these goals.

Additionally, New Jersey has recently targeted non-U.S. affiliates of domestic corporations operating in New Jersey.[40] New Jersey sends these non-U.S. affiliates a "nexus survey," and in response the non-U.S. affiliate reports that it has no physical presence in New Jersey. (It is well-established and undisputed that a corporate subsidiary, or other affiliate, does not constitute a PE of its owner or related corporations.[41]) New Jersey nevertheless responds with a tax assessment on the income that the non-U.S. corporation has received from its New Jersey affiliates.[42] Thus, New Jersey is now attempting to assert economic nexus taxation over

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2004), *cert. denied*, 126 S. Ct. 353 (2005); *Geoffrey Inc.* v. *Oklahoma Tax Comm'n*, 132 P.2d 632 (Okla. Civ. App. 2005).

[40] *See, e.g.*, Redacted Nexus Survey, July 17, 2006, *available at* http://www.ofii.org/njltr.pdf.

[41] *See, e.g.*, U.S. Model Treaty, *supra* note 13, at art. 5, para. 7; OECD Model Treaty, *supra* note 24, art. 5, para. 7.

[42] Kenneth T. Zemsky, *New Jersey Challenges U.S. Constitution's Foreign Commerce Clause*, 46 State Tax Notes 435 (Nov. 5, 2007) ("The non-U.S. affiliate's assurance that it has no physical presence . . . is met with a reply assessing a tax.").

non-U.S. corporations with no physical presence in New Jersey. New Jersey's recent actions demonstrate a dangerous expansion of the economic nexus principle internationally. New Jersey's pursuit of non-U.S. corporations with customers in New Jersey is also being conducted in a discriminatory manner because the state appears to be pursuing only those non-U.S. corporations whose in-state customers are affiliates.

Indeed, New Jersey's actions highlight the very reason that tax systems include a physical presence requirement. Tax enforcement and collection demand property present in the taxing jurisdiction. New Jersey is circumventing this practical requirement by pursuing only those non-U.S. corporations whose affiliates are physically present in New Jersey. Not only is the imposition of such a tax unwarranted, but it is also blatantly discriminatory against those non-U.S. companies which happen to be receiving income from affiliates in New Jersey, as opposed to those non-U.S companies receiving income from non-affiliates located in New Jersey.

Nor is such aggressive tax policy limited to the domestic arena. Spain and Portugal have formally registered exceptions to the portion of the OECD Model Treaty commentary discussing the fact that a

PE requires a physical presence.[43] Similarly, a report prepared by Indian tax authorities in 2001 argued for the abandonment of the traditional PE concept.[44] Most OECD members oppose these departures from the PE principle.[45]

Absent much-needed intervention by this Court, amici believe that Massachusetts — and other U.S. states — may begin taxing *non-U.S.* corporations that merely have *customers* in that state, much as New Jersey is already doing.[46] Indeed, nothing in the existing Massachusetts tax law here at issue — which is imposed on "every financial institution engaged in business in [Massachusetts]"[47] — precludes Massachusetts from doing exactly that.

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[43] *See* OECD Committee on Fiscal Affairs, Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on Article 5, Paris, 22 December 2000.

[44] *See* Ministry of Finance (India), Report of the High Powered Committee on E-Commerce and Taxation 11-12 (2001).

[45] *See* OECD Committee on Fiscal Affairs, Response to the Comments Received on the April Discussion Draft on the 2008 Update to the Model Tax Convention, July 18, 2008, at 3 (discussing the alternative PE provision described *supra* note 31, and indicating that the OECD Committee on Fiscal Affairs "as a whole does not support the use of [even this modified PE provision] and many member countries have indicated that they would resist its inclusion in their bilateral treaties").

[46] *See supra* note 42 and accompanying text.

[47] MASS. GEN. LAWS ch. 63, § 2, Pet. App. at 66a-69a.

Even more alarmingly, foreign nations will seek to tax the income of U.S. residents and corporations, even though such residents and corporations have no physical presence overseas.

II. The Decision Below Has Serious Implications for U.S. Participation in International Trade

If those engaged in international commerce cease to be able to rely on physical presence in the United States as the baseline for direct taxation by U.S. states, the U.S. likely will suffer reductions in foreign corporations investing in U.S. subsidiaries and trading with U.S. residents and corporations. In addition, because the decision below will invite foreign nations to impose tax on the business income of U.S. residents and corporations that have not even a mailbox abroad, it will cause serious damage to the competitive leadership of U.S. businesses, not to mention a dangerous encroachment on the U.S. fisc.

A. The U.S. Will Suffer A Decline in Foreign Investment

The continuing ambiguity of tax jurisdiction standards in the United States, combined with the aggressive behavior of state tax administrators, will have a deterrent effect on foreign trade in the United States. If foreign companies are faced with large and unascertainable tax liability in the United States, they will choose instead to invest in trade

with countries where bright-line jurisdictional tests are understood and followed by legislators and tax administrators.

B. U.S. Companies Will Suffer Retaliation by Other Countries

U.S. companies operating abroad will likely suffer a destructive cycle of retaliation at the hands of foreign tax regimes. As discussed *supra* in Part I.C, a few countries have already sought to expand the extra-territorial reach of their tax laws through adoption of nexus standards similar to the economic nexus standard advocated by Massachusetts. U.S. businesses, which are leaders in e-commerce and international trade, naturally have the most to lose if extraterritorial taxation has a negative impact on e-commerce and international trade activities.

Moreover, U.S. businesses will suffer the result of losing more *in* the United States than comparable foreigners operating here. This is so because U.S. states that impose taxes like those at issue here are imposing them earlier and more consistently on domestic companies than on foreign companies, leaving the domestic companies at the competitive disadvantage of effectively paying higher taxes than similarly-situated foreign businesses with U.S. customers. Additionally, U.S. states do not allow tax

credits for foreign taxes paid,[48] thus exposing U.S. companies to the dual pincers of extraterritorial taxation by U.S. states *and* the resultant, retaliatory, extraterritorial taxation by foreign nations.

Even more seriously, retaliatory extraterritorial taxation by foreign governments will reduce tax revenues to the U.S. Treasury. Since 1918,[49] the Internal Revenue Code has included a foreign tax credit system under which U.S. taxpayers are granted a credit against their U.S. taxes for income taxes they have paid to foreign taxing authorities.[50] An aggressive expansion of taxing jurisdiction by other nations, coupled with credits for such taxes that offset U.S. taxpayers' *domestic* tax liability, will have the effect of significantly reducing U.S. tax revenues. The result will be a grave detriment to the national fisc.

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[48] *See* Walter Hellerstein, State Taxation, § 7.12[3] (3d ed. 2009) ("No state allows a foreign tax credit for corporate taxpayers . . . .").

[49] *See* Revenue Act of 1918, ch. 18, Pub. L. No. 65-254, § 222(a), 40 Stat. 1057. The Internal Revenue Code has allowed a deduction for foreign taxes paid since 1913. *See* Underwood Tariff Act, Pub. L. No. 63-16, ch. 16, § II(G)(b), 38 Stat. 114.

[50] *See* 26 U.S.C. §§ 901-908 (2008) (the creditability of foreign taxes is subject to certain limitations).

In closing, consider the complications posed by the mosaic of states' extraterritorial taxation regimes for a Swiss watchmaker. Though the business is physically present only in Switzerland, sales are made to U.S. residents through the internet, and the watches are shipped to the customers by common carrier. If the watchmaker faces the risk of taxation by *each* of the fifty states, it is likely to decide that trade with U.S. residents is not worth the trouble. The Commerce Clause prevents that result, and so should this Court.

CONCLUSION

The petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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April 17, 2009

APPENDIX

APPENDIX
TABLE OF CONTENTS

APPENDIX A
DESCRIPTIONS OF AMICI CURIAE

- The Clearing House was founded over 150 years ago and is an association of leading commercial banks in the United States that provides payment, clearing and settlement services to its member banks and to other financial institutions. The Clearing House regularly appears as amicus curiae in cases that present issues of national importance to the commercial banking industry.
- The National Foreign Trade Council ("NFTC"), founded in 1914, is the oldest U.S. business association dedicated to international tax, trade, and human resource matters. The NFTC's approximately 300 members, representing the largest U.S. companies, are active advocates of free trade and a rules-based economy. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad.
- The Organization for International Investment ("OFII") is a business

association representing the U.S. subsidiaries of many of the world's largest international companies. U.S. subsidiaries of companies based abroad directly employ over 5 million Americans and support an annual U.S. payroll of $364 billion. OFII advocates fair, non-discriminatory treatment for U.S. subsidiaries to encourage foreign companies to conduct more business and create additional jobs in the United States.

- The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets.

- The United States Council for International Business ("USCIB") represents over 300 U.S.-based multinational companies, professional firms, and business associations, seeking to advance the global interests of U.S. business at home and abroad. It promotes an open system of global commerce in which business can flourish and contribute to economic growth, human welfare and protection of the environment. USCIB is the U.S. affiliate of the International Chamber of Commerce (ICC), the Business and Industry Advisory Committee to the OECD (BIAC) and the International Organization of Employers (IOE).

APPENDIX B
ALL TAX TREATIES TO WHICH THE UNITED STATES IS A PARTY, ALL CONTAINING A PERMANENT ESTABLISHMENT CLAUSE

Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation, Article 5, Oct. 31, 1983; Convention Between the Republic of Austria and the United States of America for the Avoidance of Double Taxation, Article 5, Feb. 1, 1998; Convention Between the Government of the United States of America and the Government of the People's Republic of Bangladesh for the Avoidance of Double Taxation, Article 5, Aug. 7, 2006; Convention Between Barbados and the United States of America for the Avoidance of Double Taxation, Article 5, Feb. 28, 1986; Convention Between the Government of the United States of America and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation, Article 5, Dec. 28, 2007; Convention Between the United States of America and the Republic of Bulgaria for the Avoidance of Double Taxation, Article 5, Dec. 15, 2008; Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Article 5, Aug. 16, 1984; Agreement Between the Government of the United States of America and the

Government of the People's Republic of China for the Avoidance of Double Taxation, Article 5, Oct. 22, 1986; Convention Between the Government of the United States of America and the Government of the Republic of Cyprus for the Avoidance of Double Taxation, Article 5, Dec. 31, 1985; Convention Between the United States of America and the Czech Republic for the Avoidance of Double Taxation, Article 5, Dec. 23, 1993; Convention Between the Government of the United States of America and the Government of the Kingdom of Denmark for the Avoidance of Double Taxation, Article 5, Mar. 31, 2000; Convention Between the Government of the United States of America and the Government of the Arab Republic of Egypt for the Avoidance of Double Taxation, Article 5, Dec. 31, 1981; Convention Between the United States of America and the Republic of Estonia for the Avoidance of Double Taxation, Article 5, Dec. 30, 1999; Convention Between the Government of the United States of America and the Government of the Republic of Finland for the Avoidance of Double Taxation, Article 5, Dec. 30, 1990; Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation, Article 5, Dec. 30, 1995; Convention Between the United States of America and the Federal Republic of Germany for

the Avoidance of Double Taxation, Article 5, Aug. 21, 1991; Convention Between the United States of America and the Kingdom of Greece for the Avoidance of Double Taxation, Article III, Dec. 30, 1953; Convention Between the Government of the United States of America and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation, Article 5, Sept. 18, 1979; Convention Between the Government of the United States of America and the Government of Iceland for the Avoidance of Double Taxation, Article 5, Dec. 15, 2008; Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation, Article 5, Dec. 18, 1990; Convention Between the Government of the United States and the Government of the Republic of Indonesia for the Avoidance of Double Taxation, Article 5, Dec. 30, 1990; Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation, Article 5, Dec. 17, 1997; Convention Between the Government of the United States of America and the Government of Israel with Respect to Taxes on Income, Article 5, Dec. 30, 1994; Convention Between the Government of the United States of America and the Government of the Republic of Italy for the Avoidance of Double Taxation, Dec. 30, 1985;

Convention Between the Government of the United States of America and the Government of Jamaica for the Avoidance of Double Taxation, Article 5, Dec. 29, 1981; Convention Between the Government of the United States and the Government of Japan for the Avoidance of Double Taxation, Mar. 30, 2004; Convention Between the Government of the Republic of Kazakhstan and the Government of the United States of America for the Avoidance of Double Taxation, Article 5, Dec. 30, 1996; Convention Between the United States of America and the Republic of Korea for the Avoidance of Double Taxation, Article 9, Sept. 20, 1979; Convention Between the United States of America and the Republic of Latvia for the Avoidance of Double Taxation, Article 5, Dec. 30, 1999; Convention Between the Government of the United States of America and the Government of the Republic of Lithuania for the Avoidance of Double Taxation, Article 5, Dec. 30, 1999; Convention Between the Government of the Grand Duchy of Luxembourg and the Government of the United States of America for the Avoidance of Double Taxation, Article 5, Dec. 20, 2000; Agreement Between the United States of America and the Republic of Malta with Respect to Taxes on Income, Article 5, Jan. 1, 1997; Convention Between the Government of the United States of America and the Government of the United Mexican

States for the Avoidance of Double Taxation, Article 5, Dec. 28, 1993; Convention Between the Government of the United States of America and the Government of the Kingdom of Morocco for the Avoidance of Double Taxation, Article 4, Dec. 30, 1981; Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation, Article 5, Dec. 31, 1993; Convention Between the United States of America and New Zealand for the Avoidance of Double Taxation, Article 5, Nov. 2, 1983; Convention Between the United States of America and the Kingdom of Norway for the Avoidance of Double Taxation, Article 4, Nov. 29, 1972; Convention Between the Government of the United States of America and the Government of Pakistan for the Avoidance of Double Taxation, Article III, May 21, 1959; Convention Between the Government of the United States of America and the Government of the Republic of the Philippines with Respect to Taxes on Income, Article 5, Oct. 16, 1982; Convention Between the Government of the United States of America and the Government of the Polish People's Republic for the Avoidance of Double Taxation, Article 6, July 22, 1976; Convention Between the United States of America and the Portuguese Republic for the Avoidance of Double Taxation, Article 5, Dec. 18, 1995; Convention Between the

United States of America and the Socialist Republic of Romania for the Avoidance of Double Taxation of Income, Article 5, Feb. 26, 1976; Convention Between the United States of America and the Russian Federation for the Avoidance of Double Taxation, Article 5, Dec. 16, 1993; Convention Between the United States of America and the Slovak Republic for the Avoidance of Double Taxation, Article 5, Dec. 30, 1993; Convention Between the United States of America and the Republic of Slovenia for the Avoidance of Double Taxation, Article 5, June 22, 2001; Convention Between the Republic of South Africa and the United States of America for the Avoidance of Double Taxation, Article 5, Dec. 28, 1997; Convention Between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation, Article 5, Nov. 21, 1990; Convention Between the Government of the United States and the Government of the Democratic Socialist Republic of Sri Lanka for the Avoidance of Double Taxation, Article 5, July 12, 2004; Convention Between the Government of Sweden and the Government of the United States of America for the Avoidance of Double Taxation, Article 5, Oct. 26, 1995; Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation, Article 5, Dec. 19, 1997;

Convention Between the Government of the United States of America and the Government of the Kingdom of Thailand for the Avoidance of Double Taxation, Article 5, Dec. 15, 1997; Convention Between the Government of the United States of America and the Government of Trinidad and Tobago for the Avoidance of Double Taxation, Article 9, Dec. 30, 1970; Convention Between the Government of the United States of America and the Government of the Tunisian Republic for the Avoidance of Double Taxation, Article 5, Dec. 26, 1990; Agreement Between the Government of the Republic of Turkey and the Government of the United States of America for the Avoidance of Double Taxation, Article 5, Dec. 19, 1997; Convention Between the United States of America and the Union of Soviet Socialist Republics for the Avoidance of Double Taxation of Income, Article 4 Jan. 29, 1976; Convention Between the Government of the United States of America and the Government of Ukraine for the Avoidance of Double Taxation, Article 5, June 5, 2000; Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation, Article 5, Mar. 31, 2003; Convention Between the Government of the United States of America and the Government of the Republic of

Venezuela for the Avoidance of Double Taxation, Article 5, Dec. 30, 1999.

APPENDIX C
TAX TREATIES AMONG THE G8 NATIONS AND CHINA AND INDIA, ALL CONTAINING A PERMANENT ESTABLISHMENT CLAUSE

1990 EU Arbitration Convention, Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, Section II, Jan. 1, 1995; Agreement Between the Government of Canada and the Government of the People's Republic of China for the Avoidance of Double Taxation, Article 5, Dec. 29, 1986; Convention Between Canada and France for the Avoidance of Double Taxation, Article V, July 29, 1976; Agreement Between Canada and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income, Article 5, Mar. 28, 2002; Agreement Between the Government of Canada and the Government of the Republic of India for the Avoidance of Double Taxation, Article 5, May 6, 1997; Agreement Between the Government of Canada and the Government of the Russian Federation for the Avoidance of Double Taxation, Article 5, May 5, 1997; Agreement Between the Government of the People's Republic of China and the Government of the Republic of Italy for the Avoidance of Double Taxation, Article 5, Dec. 13,

1990; Agreement Between the Government of the People's Republic of China and the Government of the Russian Federation for the Avoidance of Double Taxation, Article 5, Apr. 10, 1997; Agreement Between the Government of The French Republic and the Government of the People's Republic of China for the Avoidance of Double Taxation, Article 5, Feb. 21, 1985; Convention Between the Government of the Republic of France and the Government of Japan for the Avoidance of Double Taxation, Article 5, Mar. 24, 1996; Convention Between the Government of the French Republic and the Government of the Russian Federation for the Avoidance of Double Taxation, Article 5, Feb. 9, 1999; Elimination of Double Taxation and Establishment of Rules of Reciprocal Administrative Assistance in Fiscal Matters Between France and the SARR, Article 7, Dec. 31, 1956; Convention Between the Federal Republic of Germany and the People's Republic of China for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, Article 5, January 1, 1985; Convention Between the Federal Republic of Germany and the French Republic for the Avoidance of Double Taxation, Article 54, Nov. 4, 1961; Agreement Between the Federal Republic of Germany and the Republic of India for the Avoidance of Double Taxation with Respect to Taxes

on Income and Capital, Article 5, Oct. 2, 1996; Convention Between the Federal Republic of Germany and the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, Article 5, Dec. 24, 1992; Agreement Between the Federal Republic of Germany and the Russian Federation for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, Article 5, Dec. 30, 1996; Agreement Between the Government of the Republic of India and the Government of the People's Republic of China for the Avoidance of Double Taxation, Article 5, Nov. 21, 1994; Convention Between the Government of the Republic of India and the Government of the French Republic for the Avoidance of Double Taxation, Article 5, Aug. 1, 1994; Agreement Between the Government of the Republic of India and the Government of the Russian Federation for the Avoidance of Double Taxation with Respect to Taxes on Income, Article 5, Apr. 11, 1998; Convention Between Italy and Canada for the Avoidance of Double Taxation with Respect to Taxes on Income, Article 5, Dec. 24, 1980; Convention Between the Government of the Republic of Italy and the government of the Republic of France for the Avoidance of Double Taxation with Respect to the Taxes on Income and On Capital, Article 5, May 1, 1992; Convention Between the Government of the

Republic of Italy and the Government of the Republic of India for the Avoidance of Double Taxation, Article 5, Nov. 23, 1995; Convention Between the Government of the Italian Republic and the Government of the Russian Federation for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, Article 5, Nov. 30, 1998; Convention Between the Government of Japan and the Government of Canada for the Avoidance of Double Taxation, Article 5, Nov. 14, 1987; Agreement Between the Government of Japan and the Government of the People's Republic of China for the Avoidance of Double Taxation, Article 5, June 26, 1984; Agreement Between Japan and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and to Certain Other Taxes, Article 5, June 9, 1967; Convention Between the Government of Japan and the Government of the Republic of India for the Avoidance of Double Taxation, Article 5, Dec. 29, 1989; Convention Between Japan and the Republic of Italy for the Avoidance of Double Taxation with Respect to Taxes on Income, Article 5, March 17, 1973; Convention Between the Government of Japan and the Government of the Union of Soviet Socialist Republics for the Avoidance of Double Taxation with Respect to Taxes on Income, Article 5, Nov. 27, 1986; Convention Between the Government of the United

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Federation for the Avoidance of Double Taxation, Article 5, Apr. 18, 1997; Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Article 5, Aug. 16, 1984; Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation, Article 5, Nov. 21, 1986; Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation, Article 5, Dec. 30, 1995; Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation, Article 5, Aug. 21, 1991; Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation, Article 5, Dec. 18, 1990; Convention Between the Government of the United States of America and the Government of the Republic of Italy for the Avoidance of Double Taxation, Article 5, Dec. 30, 1985; Convention Between the Government of the United States and the Government of Japan for the Avoidance of Double Taxation, Article 5, Mar. 30, 2004; Convention Between the United States of America and the Russian Federation for the Avoidance of Double Taxation, Article 5, Dec. 16, 1993;

Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation, Article 5, Mar. 31, 2003.

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Supreme Court of the United States

CAPITAL ONE BANK N.A., FKA CAPITAL ONE et al,
Petitioner,

v.

COMMISSIONER OF REVENUE OF MASSACHUSETTS,
Respondent.

GEOFFREY, INC.,
Petitioner,

v.

COMMISSIONER OF REVENUE OF MASSACHUSETTS,
Respondent.

On Petition for a Writ of Certiorari to the Commonwealth of Massachusetts Supreme Judicial Court

BRIEF OF *AMICI CURIAE* OF COUNCIL ON STATE TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS, AND NATIONAL MARINE MANUFACTURERS ASSOCIATION IN SUPPORT OF PETITIONER

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES Page

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

INTEREST OF *AMICI CURIAE*

This brief *amici curiae* in support of petitioners is filed on behalf of three trade associations representing the largest businesses in our nation's state and local economies.[1] Unless this Court clarifies whether in-state physical presence remains the standard by which a business becomes subject to a state's income and franchise tax jurisdiction, the thousands of members of *amici's* associations will face substantial costs in determining their tax liabilities and in some instances will not be able to ascertain those liabilities accurately at all. This uncertainty regarding tax compliance obligations increasingly creates significant and impermissible burdens on interstate commerce.

The Council On State Taxation ("COST") is a nonprofit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. COST represents more than 600 of the largest multistate businesses in the United States, including companies in every industry. Many of COST's members have customers in states where the members have no property or employees—that is, in states where the members have no "physical presence."

The National Association of Manufacturers ("NAM") is the nation's largest industrial trade association, representing small and large manufac-

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici curiae* has made a monetary contribution to the preparation or submission of this brief. The parties received timely notice of *amici's* intent to file this brief. Written consent of all parties to the filing of this brief has been filed with the Clerk of this Court.

turers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media, and the general public about the vital role of manufacturing to America's economic future and living standards.

The National Marine Manufacturers Association ("NMMA") is the nation's largest recreational marine industry association, representing more than 1,500 boat builders, engine manufacturers, and marine accessory manufacturers. The recreational boating industry is a substantial contributor to the nation's economy with sales of recreational marine products and services totaling more than $37.5 billion in 2007 alone. Because their business activities are typically multistate in nature, the NMMA's members have an important interest in the question presented. In addition, the majority of NMMA members are small businesses with limited resources to navigate complex state tax regimes.

SUMMARY OF THE ARGUMENT

Historically, a corporation's physical presence in a state served as the prerequisite for any type of tax, including income and franchise tax. In *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 754 (1967), and *Quill v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the context of sales and use taxes. However, many states continue to expand aggressively their own tax revenues by asserting the power to tax the corporate income of out-of-state businesses that have no physical presence in the taxing state. States have

adopted a variety of expanded "nexus" standards through judicial, legislative, and administrative action. These standards—which are unclear and vary widely from state to state—are highly burdensome for taxpayers doing business in multiple jurisdictions and thus place an enormous burden on interstate commerce. As the scope of these standards have been judicially tested, the highest courts of Massachusetts, West Virginia, New Jersey, and South Carolina have all held that the Commerce Clause does not prevent the imposition of income and franchise taxes upon out-of-state corporations with no physical presence in the state. While some state appellate courts have issued similar decisions, others have held the opposite.

The importance of the Court's review of the Massachusetts decisions extends well beyond the direct conflict among state courts regarding the meaning of the Commerce Clause. To be sure, this Court's review is urgently needed because departures from the physical presence rule and the resulting uncertainty over the jurisdictional grounds of state taxation have themselves generated an impermissible burden on interstate commerce. Thus, these cases present the special circumstance where divergent approaches by different states have produced the very constitutional evil that the Commerce Clause was meant to avoid.

The uncertainty in calculating a multistate business's state income or franchise tax liability stems both from (i) the divergent approaches taken by different states and (ii) the nebulous and unpredictable nature of alternatives to the physical presence rule. The uncertainty generates a considerable increase in compliance costs and administrative burdens, as well as problems in determining and reporting the business's tax liability for required financial statements.

A business that cannot accurately ascertain its tax liability, even internally, can hardly be expected to make meaningful disclosures to investors. As a result, there are real economic losses when a company decides not to exploit an otherwise profitable opportunity (such as expanding its business into a new state) because of the expense and uncertainty inherent in state tax jurisdiction rules. The abandonment of the traditional "physical presence" rule thus entails deadweight losses (in the form of unnecessary compliance costs), lower business productivity, slower growth, fewer jobs, and additional burdens on interstate commerce. The same reasons that animated this Court's grant of review in *Quill* militate strongly in favor of certiorari in these cases. In fact, this Court's review is much more compelling here than in *Quill* because state corporate income taxes are more burdensome than the collection of sales and use taxes. The costs of compliance are much greater, and the threat to interstate commerce is immediate.

ARGUMENT

I. UNCERTAINTY REGARDING STATE AND LOCAL TAX COMPLIANCE OBLIGATIONS CREATES AN IMPERMISSIBLE BURDEN ON INTERSTATE COMMERCE

A. The Physical Presence Rule Is Necessary To Provide Clarity and Predictability

Physical presence has traditionally served as the basis for the imposition of corporate income and franchise taxes. In *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), this Court held that a systematic program of direct mail advertising was not sufficient to justify imposition of use tax on an

out-of-state seller. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the sales and use tax context as a limit "firmly establish[ing] the boundaries of legitimate state power." *Id.* at 315.

The physical presence rule is a bright-line rule that provides a business with an adequate understanding of when and where it will be subject to tax. As a leading constitutional scholar has observed, the rule "provides some measure of stability to parties engaged in commercial interchange and provides a more hospitable environment for the flourishing of nascent modes of free-floating interstate commerce, which might otherwise perish on the rocky shoals of overmuch state taxation." 1 Laurence H. Tribe, AMERICAN CONSTITUTIONAL LAW 1125 (3d ed. 2000).

However, some states have departed from the physical presence rule in the imposition of corporate income and franchise taxes. Massachusetts has adopted an "elastic" substantial nexus test, which would permit the State to tax the income of any business with *customers* in the taxing state, even if it lacked any real or tangible personal property, employees, or other contacts there. Other states have adopted their own "nexus" standards, whose nebulous nature and non-uniform definitions make it highly burdensome for multistate businesses to comply. *See, e.g., Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13, 18 (S.C.) *cert. denied*, 510 U.S. 992 (1993) ("by licensing intangibles for use in this State and deriving income from their use here, [taxpayer] has a 'substantial nexus'" with state); *see also Buehner Block Co. v. Wyo. Dep't of Revenue*, 139

P.3d 1150, 1158 n.6 (Wyo. 2006).[2] Still other states have made statutory or administrative changes asserting authority to tax corporations with no physical presence.[3]

As states adopt their own versions of a "nexus" test, multistate taxpayers face a variety of different standards and vague guidelines. Taxpayers are denied a clear understanding of their tax liabilities as states base their "determinations of whether nonresident corporations are subject to tax on a subjective facts and circumstances analysis". Megan A. Stombock, *Economic Nexus and Nonresident Corporate Taxpayers: How Far Will It Go?*, 61 THE TAX LAWYER 1225, 1238 (2008). It is often unclear to taxpayers whether they are even required to pay tax in a jurisdiction at all. As observed by commentators:

> [W]e are now in a world in which a business, remotely present in multiple states, is faced with a wide range of nexus standards regarding the

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[2] *See also Bridges v. Geoffrey, Inc.*, 984 So.2d 115 (La. Ct. App. 2008), *writ denied*, 978 So.2d (La. 2008); *Lanco, Inc. v. Director, Div. of Tax.*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S. Ct. 2974 (2007); Kmart *Props., Inc. v. Taxation & Revenue Dep't of N.M.*, 131 P.3d 27 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 546 U.S. 821 (2005); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005); *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. App.), *pet. rev. denied en banc*, 84 P.3d 1230 (Wash. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Tax Comm'r v. MBNA America Bank*, 640 S.E.2d 226 (W. Va. 2006), *cert. denied*, 127 S. Ct. 2997 (2007).

[3] *See, e.g.*, Ark. Reg. 1996-3 (2009); Fla. Admin. Code Ann. r. 12C-1.011 (p)1 (2009); Iowa Admin. Code r. 701.52.1(422), 52.1(1)d (2009); Minn. Stat. § 290.015(1)(c)(3) (2009); Okla. Admin. Code § 710:50-17-3(a)(9) (2009).

> complex commercial transactions. The convergence of these trends, the blurring of nexus standards, and the increasing complex global economy call into question the ability to fairly administer the current state and local taxing system.

Giles Sutton, Eric de Moya, and Chuck Jones, *Attributional Nexus, Flash Title, And the Chaos in Nexus Standards*, 50 STATE TAX NOTES 491 (2008).

Two months ago, Wisconsin significantly changed its law pertaining to economic nexus without any hearings or public debate. The new law, which imposes tax on anyone "regularly soliciting business from potential customers in this state," raises many difficult questions taxpayers must address to determine precisely what activities give rise to economic nexus in the State. Wisc. Stat. § 71.22(1r) (2009).

The current confusion surrounding income tax nexus is not that different from the situation this Court faced in *Quill* when addressing sales and use taxes. The Court acknowledged then "our law in this area is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensible power of taxation." *Quill*, 504 U.S. at 315 citing *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-58 (1959)). The current uncertainty offends the core values protected by the Commerce Clause and amply warrants this Court's review.

B. Departures From The Physical Presence Rule Create Substantial Compliance Costs For Multistate Businesses

In *Quill*, this Court recognized that anything but a physical presence rule would be an undue burden on interstate commerce, because of the significant cost of compliance with sales and use tax laws in a multistate environment. The same conclusion applies *a fortiori* in these cases, because corporate income tax compliance is substantially more complex and burdensome than the sales and use tax compliance analyzed in *Quill*. In the sales and use tax context, only two broad questions must be asked and answered: Is the item taxable or non-taxable? If the item is taxable, what is the applicable tax rate? The burdens uniquely associated with uncertainty are few with respect to sales and use taxes, because compliance is straightforward.

In contrast, corporate income tax is demonstrably more complex because there are dozens of independent questions and judgments that must be made in calculating a corporate income tax liability. Without a physical presence rule, companies would need to examine these questions on a jurisdiction-by-jurisdiction, corporate-entity-by-entity, and year-by-year basis. Record-keeping in the corporate income tax context is also significantly more elaborate than in the area of sales and use taxes where only the records of sales need be retained. The number of potential taxing jurisdictions at the state and local level that can impose a business activity tax is dramatically higher than the number of jurisdictions imposing a sales and use tax. *See Quill*, 504 U.S. at 313 n.6. Multistate businesses face the prospect of

taxation not only in 50 states, but also in thousands of localities authorized to impose corporate income, franchise and other business activity taxes.

In the absence of a physical presence rule, multistate businesses will face significant costs in trying to determine the jurisdictions in which they face potential tax liabilities and the applicable rules of those jurisdictions. Some may be unable to ascertain accurately their tax liabilities at all. Each multistate business—large and small—must analyze a long list of issues for every jurisdiction where it has a commercial profile. Listing all of the issues a taxpayer must address before complying with the numerous individual state income tax rules would easily exceed the maximum page count allowed for this brief. However, an abbreviated description of the archetypal issues can provide a hint of the task involved.

1. Return Filing Methods

States have numerous types of income tax returns with inconsistent and overlapping names and frequently opaque rules. While some states adopt standard federal consolidated reporting concepts, most do not. The lack of any uniformity in this area creates an enormous burden on any taxpayer seeking to comply. A passing list of the issues a taxpayer faces when choosing the appropriate type of return includes:

- Is combined reporting (a method where affiliated businesses file as one unit) allowed, prohibited, or elective?
- What are the requirements for an affiliate to be included or excluded from the combined report?

- What are the ownership rules for an affiliate to be eligible for inclusion in the combined report? Are there beneficial ownership rules? What types of stock are considered in the ownership test—preferred stock, convertible bonds, restricted stock?

- Does the state require only that the affiliates be unitary?

- What is the definition of a "unitary business" in any given state—the "contribution and/or dependency test," the test articulated in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), the test cited in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), or a state-created test?

- Does the state have some type of additional test such as a requirement that the calculation of a company's income tax is distortive? If so, what is considered distortion?

- How are partnerships and other pass-through entities treated? Is the pass-through entity included in the combined report if its majority owner is the combined group? Is only its income allocated to the member included in the tax base or is its total income included?

- What types of entities and businesses may or must be included in a combined return and which must be excluded? For example, may an insurance company be included with its non-insurance affiliates? Are Puerto Rico affiliates included?

2. Filing Requirements and Mechanics

Once the type of return and which entities should be included on the return is determined, the taxpayer must determine how to file and pay the tax, obtain a refund, or seek an extension.

- When are estimated tax payments due? Are payments due ratably throughout the year, or are different percentages of tax due at different estimate dates? What happens to short tax years?
- Must the return be filed electronically? Must the payment be sent electronically?
- What are the procedures for amendments and adjustments? Some states piggy-back onto federal extension filings while others require separate applications for an extension of time to file a tax return.

3. Tax Base Computations and Adjustments

Multi-jurisdictional taxpayers also face differing state definitions of the tax base. Most states use federal taxable income as a starting point, but five states do not. Even among the states that use federal taxable income as the starting point, every state has unique addition and subtraction modifications that result in a substantial divergence in the ultimate state tax base from the federal base (and among the states' bases themselves). Corporations typically must keep numerous schedules for each state to track the differences in asset and liability basis, net operating losses (NOLs), depreciation, and other variations from the federal rules.

Typical issues that taxpayers face include:

- Does the state follow federal depreciation rules? Most states have departed from the federal bonus depreciation in recent years, but many departed in differing ways. This means taxpayers must keep multiple sets of depreciation calculations for the same business equipment.
- How does a state calculate NOLs? Does it follow the federal carryback and carryforward rules, or does it have its own time period? Taxpayers typically have many different NOL calculations in many different states, none of which matches the federal NOL amount.
- How does a state treat dividends from affiliates? Does it use the same percentages and stock ownership rules as the federal government? What percentage of ownership is required to obtain a dividend received deduction?

4. Income Apportionment and Allocation.

The concept of allocation and apportionment does not exist at the federal level and thus is a unique burden created by state tax laws. Over the years, states have adopted an increasingly varied set of rules for these issues. "Apportionment" generally means how the income from typical activities of a taxpayer is spread out among the taxing states. A formula is used to determine the percentage of income subject to tax in each state. Historically, an equally weighted three-factor formula consisting of property, payroll, and sales was used to determine the business activity, and thus the percentage of taxable income, that each state could claim. However,

there is currently very little uniformity among states. Other apportionment and allocation issues include:

- What items are included in the "property" factor?
- How is property valued?
- What and who is included in the "payroll" factor? Are non-cash benefits included? Is deferred compensation included? Are the salaries of the officers and directors included? To what jurisdiction is an employee's salary assigned? What if the employee has no permanent office but telecommutes, or spends all of his or her time on the road traveling between clients in five different states? Is the compensation of a taxpayer's independent contractors included?
- What is included in the "sales" factor? To what jurisdiction are sales of services and intangible property assigned?
- Do certain industries, such as manufacturing, receive a special apportionment formula, such as a single sales factor formula, as an incentive to relocate, expand, or remain in the state, and if so, how is that industry defined? Are certain industries assigned apportionment formulas different from the standard formula because of a unique business model—such as financial institutions, trucking companies, or broadcasting companies?
- When is a taxpayer required to apportion its income among all of the states in which it does business (*i.e.*, business income)? When must it allocate its income from a certain

transaction to one state (*i.e.*, non-business income)? What is the definition of business income?

- If a taxpayer must allocate its income from a certain activity to one state, which state is it? Is it the taxpayer's state of legal domicile, or the state in which it has its headquarters?
- What are the statutory rules for applying an apportionment formula that differs from the statutory formula? How does a taxpayer apply for an alternative formula and what evidence must it present? Can the state impose an alternative formula under the same theory? What types of alternatives are available?[4]

By itself, this list of questions is burdensome. But the abandonment of the "physical presence" rule compounds the burden by multiplying the number of jurisdictions in which a multistate business must resolve the uncertainties. Technology alone cannot solve the problem, because the ambiguities require human analysis and judgment. A potential taxpayer

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[4] This list of issues is not exhaustive. Added burdens stem from the cost of maintaining adequate documentation, which is multiplied as the number of taxing states increases. Further issues arise when the state tax is based on something other than income—such as assets, paid-in-capital, or gross receipts. In addition, the complexity does not end when the return is filed. Large corporations are under almost continuous audit by many states. The more jurisdictions in which the company is required to file and pay tax, the more audits to which the company will be subject. Audits require answering numerous documentation requests, conducting interviews with employees, and entering into negotiations and potential litigation. All of these items carry significant direct costs and also reduce productivity.

must answer these questions in every state and locality in which it conceivably has an economic nexus—a truly daunting task in light of the 12,600 state and local jurisdictions that have the authority to impose a business activity tax.

Without the physical presence rule, businesses must monitor every state and locality in which they have any type of commercial profile. They will be required to track state tax legislation and regulatory developments constantly, become familiar with potential changes in tax law, and stand ready to implement those changes accordingly. Studies show that state income tax compliance costs are already significant, amounting to double the costs of federal tax compliance, when computed relative to the respective tax liabilities.[5] Departures from the physical presence rule will only make the problem worse and will trigger a significant impact on interstate commerce.

C. Uncertainty Leads To Substantial Opportunity Costs

The additional compliance burdens attributable to uncertainty have real and substantial opportunity costs as well, magnifying the harm to interstate commerce. For example, a company deciding whether to expand its operations in a multistate fashion will necessarily consider whether the additional cost and complexity of tax compliance outweigh the business benefits of expansion. At the margin, the uncertainty

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[5] Sanjay Gupta and Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?* 56 NAT'L TAX J. 355, 363 (2002). For the largest 1,000 firms, the ratio of state compliance costs to state income tax expenses is 2.9%, or more than twice the federal ratio of 1.4%.

caused by departures from the physical presence rule will cause companies to choose business activities that avoid compliance costs but are of lesser value to the business, society and the economy. Such a choice, inherent in any system that requires taxation, is exacerbated as the costs of compliance increase.

Such market distortions are exactly what the Commerce Clause was meant to prevent. The national economy is artificially constricted when a company does not enter new jurisdictions even though there is demand for the company's product, or does not pursue a new line of business at all because it would subject the company to the jurisdiction of additional states under a vague "economic presence" standard. The inherent uncertainty caused by departures from the physical presence rule will aggravate the distortions in economic choice.

D. The Impact on Small Businesses Will Be Severe

Although these cases deal with large corporate taxpayers, the effects on small and mid-sized businesses of abandoning the physical presence rule will be severe. Smaller businesses do not have the resources or capability to comply with the multitude of state and local tax laws that are certain to be triggered by the economic nexus standard. For example, one study determined that for firms with \$5 million or more in assets, the "average total compliance costs systematically increase with increasing firm size as measured by asset size."[6] "Consistent with all earlier

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[6] Joel Slemrod and Varsha Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Businesses: A Report to the IRS LMSB Division*, Univ. Mich. Bus. Sch. (Sept. 2002). Firms in the \$5 million to \$10 million asset category had an

research, compliance costs are regressive in the sense that those costs as a percentage of firm size are higher for smaller firms than they are for larger firms."[7] Thus, abandoning the physical presence rule will have a disproportionate impact on small and mid-sized corporate taxpayers.

II. ABANDONING THE PHYSICAL PRESENCE RULE FRUSTRATES THE GOAL OF ACCURATE FINANCIAL DISCLOSURE.

Departing from the physical presence rule will also create accounting difficulties and will frustrate the goal of accurate and transparent financial disclosures at the heart of the federal securities laws. A company that cannot accurately predict its state income tax liability, even internally, can scarcely be expected to provide meaningful information to investors.

The problem is made more acute by recent tightening of financial disclosure requirements. In 2006, the Financial Accounting Standards Board (FASB), adopted new rules on accounting for uncertain income tax positions. *FASB Increases Relevance and Comparability of Financial Reporting or Income Taxes: Final Interpretation Reduces Widespread Diversity in Practice*, News Release (FASB) (July 13, 2006) ("FIN 48"). FIN 48 provides uniform criteria

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average of $35,443 in compliance costs; firms in the $10 million to $50 million category spent $93,876 on average; firms with assets from $50 million to $100 million spent $149,876 on average; firms ranging from $100 million to $250 million in asset size spent an average of $243,492; and firms with $250 million to $1 billion in assets had an average of $1,331,643 in compliance costs. *Id.* at 15.

[7] *Id.*

for the preparation of financial statements and expands the disclosure required regarding uncertainty in income taxes. FIN 48 mandates a "reserve" for 100% of tax items unless it is "more likely than not" that the company will prevail in litigation on those items. This reserve is of indefinite duration, with interest and penalties accruing annually.

The abandonment of the physical presence rule along with the adoption of varying "nexus" or "economic presence" standards by different states creates havoc for the financial statements of publicly traded companies. Under FIN 48, a company with customers but no physical presence in a state or locality is required to decide whether it is "more likely than not" that it will be deemed, after the fact, to lack a requisite nexus with that jurisdiction. The ambiguous and evolving nature of the concept of "nexus" makes it extremely difficult to decide, to a 50% certainty, whether a company will be deemed to have a nexus in a given state or locality. In fact, it may very well create a never-ending dilemma for many multistate companies.

If a business determines it does not have the requisite activity to create nexus in a state and thus does not file a return there, the statute of limitations for an assessment often never expires. Thus, a business may be in the awkward position of taking a reasonable position regarding its tax filing requirements in a given state, but because of the controversial and unsettled state of the law on nexus, the business may be unable to reach the required confidence level ("more likely than not") on the validity of its financial statement reporting position under FIN 48. As a result, this phantom tax liability to the state (plus accrued phantom penalties and interest) will never disappear

from its financial statements unless the business is actually audited and the state determines it does not have nexus.

The varying and ill-defined "economic presence" standards adopted by the states will therefore frustrate the goal of providing investors with a realistic picture of a corporation's financial position. Hence, abandoning the physical presence rule disserves the purposes of the securities laws as well as the Commerce Clause.

CONCLUSION

The petitions for writ of certiorari should be granted.

Respectfully submitted,

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IN THE

Supreme Court of the United States

CAPITAL ONE BANK (USA), N.A.,
F/K/A CAPITAL ONE BANK, AND CAPITAL ONE, N.A.,
AS SUCCESSOR TO CAPITAL ONE F.S.B.
Petitioners,

v.

COMMISSIONER OF REVENUE OF MASSACHUSETTS,
Respondent.

On Petition for a Writ of Certiorari to the Massachusetts Supreme Judicial Court

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF THE PETITIONER

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF THE PETITIONER

INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of the petition for a writ of certiorari.[1] Tax Executives Institute (here-

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[1] Pursuant to Rule 37.6, *amicus* Tax Executives Institute, Inc. states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Pursuant to Rule

inafter "TEI" or "the Institute") is a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. TEI was organized in 1944 under the laws of the State of New York and is exempt from taxation under section 501(c)(6) of the Internal Revenue Code (26 U.S.C.). The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws, reducing the costs and burdens of compliance to the benefit of both the government and taxpayers, and vindicating the Commerce Clause and other constitutional rights of all business taxpayers.

TEI's 7,000 members represent more than 3,200 of the leading corporations in the United States, Canada, Europe and Asia, including many domiciled or doing business in Massachusetts. TEI members represent a cross-section of the business community whose employers are, almost without exception, engaged in interstate commerce. TEI has a keen interest in the issues raised by the decision of the Supreme Judicial Court of Massachusetts in this case – and in that court's related decision in *Geoffrey, Inc. v. Massachusetts Department of Revenue*, 453 Mass. 17 (2009) – and TEI members will be materially affected by the Court's disposition of this matter.

The issue presented in this case is whether the imposition of the Massachusetts Financial Institution Excise Tax ("FIET") on out-of-state taxpayers having no physical presence within Massachusetts violates

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37.2(a), counsel of record for both parties received timely notice of the intent to file an amicus brief under this rule and both parties have consented to its submission in letters filed with the Clerk.

the Commerce Clause of the United States Constitution. In *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), and again in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Court set forth a bright-line rule requiring an enterprise have physical presence in the State before being subject to taxation. If the Court were to overrule or narrow these existing holdings, two correlative questions would have to be addressed: (1) whether the Commerce Clause "substantial nexus" requirement as stipulated in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), is met by an enterprise's "economic presence" in the State, and (2) whether the nexus thresholds in the FIET rise to the level of a sufficient economic presence.

ARGUMENT

I. OVERVIEW

During the periods at issue in this case, Capital One Bank (now Capital One Bank (USA), N.A.) and Capital One F.S.B. (now Capital One, N.A.) (collectively, "Banks") were both wholly owned subsidiaries of Capital One Financial Corporation, a publicly traded corporation listed on the New York Stock Exchange. Capital One Bank, during the periods at issue in this case, was a Virginia chartered credit card bank offering Visa and MasterCard credit cards to its customers. Capital One F.S.B. is a federally chartered savings bank that offers consumer lending and deposit products to its customers, including secured and unsecured credit cards and unsecured installment and consumer home loans. Both entities were at the time domiciled in Virginia.

The Banks have no employees, real property, or tangible property in Massachusetts. Their nation-

wide credit card business is conducted solely through the Internet, mail, television advertising, and long distance telephone solicitations, some of which reach residents of Massachusetts. These solicitations are neither initiated in nor from Massachusetts. In addition, the Banks neither receive nor process any accounts receivable in Massachusetts. The Banks, do however, derive receipts (primarily, finance charges) from customers who are Massachusetts residents.

After analyzing the Banks' activities, the Massachusetts Department of Revenue ("Department") determined that the Banks were subject to the FIET as a result of their "economic presence" in the Commonwealth. The Banks appealed this determination to the Massachusetts Appellate Tax Board. Finding that economic presence alone created nexus in the State, the Board found in favor of the Department. The Banks appealed this decision, and the Massachusetts Supreme Judicial Court agreed that the Banks' economic presence in Massachusetts created nexus in the Commonwealth causing the Banks to be subject to the FIET.

II. STATES HAVE DISREGARDED THIS COURT'S NEXUS JURISPRUDENCE, SPAWNING AN UNWORKABLE PATCHWORK OF INCONSISTENT STANDARDS THAT VIOLATE THE COMMERCE CLAUSE

More than 40 years ago, this Court held that under the Commerce Clause of the Constitution an enterprise must be physically present in a State for the State to subject the enterprise to taxation. Regrettably, the States have taken the Court's clear guidance and blurred it through inconsistent, vague, and over-

broad standards creating uncertainty where there rightly should be none.

In 1967, this Court held in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), that a sales and use tax could not constitutionally be imposed on a vendor whose only contacts with the taxing State were through the mail and by common courier.[2] A decade later, in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), this Court reiterated that a threshold requirement of the Commerce Clause is the presence of "sufficient nexus" between the State and the person, property, or transaction to be taxed. *Id.* at 279. Fifteen years later in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Court confirmed the vitality of the *Complete Auto Transit* construct and effectively harmonized that decision with the clear guidance enunciated in *National Bellas Hess*. It also reaffirmed the constitutional prerequisite for Commerce Clause purposes of the taxpayer's physical presence in the taxing jurisdiction.[3] *Id.* at 308. Thus, *Quill* con-

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[2] In *National Bellas Hess*, the Court struck down Illinois's effort to require an out-of-state mail-order business to collect use tax on mail-order sales made to state residents on both due process and Commerce Clause grounds. The Court explained that permitting the imposition of a use tax collection duty on a business that maintained no physical presence in the State would give rise to "unjustifiable local entanglements" of interstate commerce. 386 U.S. at 760. The Court reasoned that the administrative and recordkeeping requirements that could arise in the absence of a physical presence test "could entangle National [Bellas Hess]'s interstate business in a virtual welter of complicated obligations to local jurisdictions . . . ." *Id.* at 759-60.

[3] The Court in *Quill* overruled the part of *National Bellas Hess* holding that physical presence is also required for *due process* purposes. 504 U.S. at 308.

firmed that a vendor whose only contacts with the taxing State are by mail or common-carrier lacks the substantial nexus required by the Commerce Clause. *Id.*

In *Quill*, the Court embraced *National Bellas Hess*'s bright-line, physical-presence test of Commerce Clause nexus not only because such a test "furthers the ends of the dormant Commerce Clause" by "demarcati[ng] . . . a discrete realm of commercial activity that is free from interstate taxation," *id.* at 315, but because it fosters the "interest in stability and orderly development of the law" that undergirds the doctrine of *stare decisis. See Runyon v. McCrary*, 427 U.S. 160, 190-91 (1976) (Stevens, J., concurring) (quoted in *Quill Corp.*, 504 U.S. at 315).[4] The Court in *Quill* did not explicitly extend its holding beyond the sales and use tax area, but did caution that its declining to articulate a physical-presence test in other areas "does not imply repudiation of the *[National] Bellas Hess* rule" in those areas. *Id.* at 314.

Despite the Court's caution in *Quill*, States have ignored the core teaching of the decision and have sought to exploit the facts of the case and necessary narrowness of the Court's holding to stretch the concept of nexus outside of the sales and use tax context. The refusal of the States to follow *Quill* has placed a heavy burden on interstate commerce as taxpayers are forced to expend time and energy in order to vindicate their constitutional rights, contend with the attendant uncertainty, and – absent intervention of this Court – pay taxes beyond what the Constitution

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[4] "[T]he continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate the *[National] Bellas Hess* rule remains good law." *Quill Corp.*, 504 U.S. at 317.

allows. In holding that "the constitutionality, under the commerce clause, of the Commonwealth's imposition of the FIET is determined not by *Quill*'s physical presence test, but by the 'substantial nexus' test articulated in *Complete Auto*," *Capital One Bank v. Commissioner of Revenue*, 453 Mass. 1, 15 (2009), the Massachusetts court provided yet another example of the extraterritorial taxation that has been occasioned by the amorphous economic nexus standards conjured by States.

Regrettably, State after State has read the Court's opinion in *Quill* as license to extend the reach of their taxing powers outside of the sales and use tax context with impunity. The first State to take advantage of this approach was South Carolina. In *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993), the South Carolina Supreme Court determined that the use of intangible property by an affiliated company crossed the substantial nexus threshold even though the taxpayer had no physical presence in the State.

Following this Court's declining to review the decision in *Geoffrey*, other States followed South Carolina's lead to distend the constitutional nexus standard. For example, the New Mexico Court of Appeals opined that "the use of . . . [the out-of-state corporation's] marks within New Mexico's economic market, for purposes of generating substantial income," established sufficient nexus to satisfy the Commerce Clause. *Kmart Properties, Inc. v. New Mexico Taxation and Revenue Department*, 131 P.3d 27, 36 (N.M. Ct. App. 2001).[5]

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[5] On the other hand, the Tennessee Court of Appeals held – in a case with facts much more similar to those of this case – that

Similarly, state legislatures and state departments of revenue have created far-reaching and vague corporate income tax nexus standards untethered to in-state physical presence. Under Georgia's statute, a taxpayer is subject to tax if it derives—

> income from sources within this state to the extent permitted by the United States Constitution. A corporation shall be deemed to be doing business within this state if it engages within this state in any activities or transactions for the purpose of financial profit or gain whether or not . . . [t]he corporation maintains an office or place of doing business within this state.

Ga. Code Ann. § 48-7-31(a). The State of Illinois imposes "a tax measured by net income on . . . [every] corporation for the privilege of earning or receiving income in . . . [the] state," 35 Ill. Comp. Stat. 5/201(a), and does not require a physical presence in the state. *See* Ill. Admin. Code tit. 86 § 100.9720. Louisiana imposes its corporation income tax on net income earned or derived from sources within the State and also does not require a physical presence. *See* La. Rev. Stat. Ann. § 47:287.67. Other States have enacted similarly expansive – but not consistent – nexus rules.[6] However facile the State's reasoning,

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Commerce Clause nexus was lacking where an out-of-state bank was not physically present in the State. *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999).

[6] For example, the District of Columbia imposes its corporation franchise tax on the amount of net income derived in the District for "the privilege of carrying on or engaging in any trade or business within the District *and* of receiving . . . income . . . from sources within the District." D.C. Code Ann. § 47-1810.01 (emphasis added). *See also* D.C. Code Ann. § 47-1805.02(5).

these broad and uncertain standards impermissibly burden interstate commerce.

Two years ago, this Court declined the opportunity to address this issue in the context of a credit card issuer by denying certiorari in *Tax Commissioner v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (2006), *cert. denied*, __ U.S. __, 127 S. Ct. 2997 (2007). While the Court's action formally has no precedential status,[7] that is not how the States interpreted it. Indeed, as was the case following the Court's 1993 denial of certiorari in *Geoffrey, Inc. v. South Carolina*, many States brazenly took the denial of certiorari in *MBNA* as a green light to extend their nexus standards by fashioning ever expanding variations on the economic nexus theme. Thus, New Hampshire codified an open-ended standard that reaches any "purposeful direction of business toward the state." N.H. Rev. Stat. Ann. § 77-A:1(XII) (effective July 1, 2007). In Wisconsin, the legislature pushed the constitutional envelope further by enacting legislation defining nexus to include—

> regularly soliciting business from potential customers in this state; regularly performing services outside this state for which the benefits are received in this state; regularly engaging in transactions with customers in this state that involve intangible property and result in receipts flowing to the taxpayer from within this state; holding loans secured by real or tangible personal property located in this state.

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[7] "The denial of a writ of certiorari imports no expression of opinion upon the merits of the case, as the bar has been told many times." *United States v. Carver*, 260 U.S. 482, 490 (1923).

Wis. Stat. § 71.22(1r) (effective January 1, 2009). Finally, earlier this year California stretched its nexus definition to include corporations having gross receipts from California sources in excess of $500,000 or a sales factor of more than 0.25 percent (sales for this purpose include sales made by independent contractors and agents) – regardless of any physical presence in the State. Cal. Rev. & Tax Code § 23101 (effective January 1, 2011).

Following the refusal to grant certiorari in *MBNA*, state departments of revenue have also aggressively interpreted existing corporate income tax nexus statutes. In October 2007, the Florida Department of Revenue ruled that its "position is that physical presence . . . [is] not required to impose Florida's corporate income tax." Florida Department of Revenue, Technical Assistance Advisement (TAA) #07C1-007 (October 17, 2007).

Likewise, Maine Revenue Services simply stated that it "considers taxpayers with economic nexus alone to be subject to Maine's income tax laws." Maine Revenue Services, Tax Alert, Vol. 18, Issue 2 (February 2008). This publication notes as support for this expansive interpretation that "[t]he State Tax Assessor construes Maine law to assert the tax jurisdiction of Maine to the full extent permitted by the Constitution and laws of the United States." *Id.*

The Oregon Department of Revenue, too, promulgated an expansive nexus regulation in May 2008, providing that "[s]ubstantial nexus exists where a taxpayer regularly takes advantage of Oregon's economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state." Oregon Administrative Code § 150-317-010(2).

Finally, the Iowa Department of Revenue issued two rulings in 2008 that strain even the broadest reading of the Court's guidance on the substantial nexus standard. In one case, the Department ruled that an out-of-state corporation had nexus with the State solely as a result of licensing software to customers in Iowa. Iowa Department of Revenue, Policy Letter 08240032 (May 14, 2008). In the second case, the Administrative Hearings Division of the Iowa Department of Inspections and Appeals ruled that an out-of-state franchisor had nexus in Iowa since an in-state franchisee was required to pay the franchisor based on the gross revenue of the franchisee's business in Iowa. *KFC Corp. v. Department of Revenue*, Iowa Department of Inspections and Appeals, Hearings Division, Docket No. 07DORFC016 (August 8, 2008).

Even States that previously followed the physical presence nexus standard have exploited the vacuum created by the lack of Supreme Court guidance since 1992. For example, in 1993, the Michigan Court of Appeals held that "after *Quill*, it is abundantly clear that Guardian [the taxpayer] must show a physical presence within a target state to establish a substantial nexus to it." *Guardian Industries Corp. v. Department of Treasury*, 499 N.W.2d 349, 353 (Mich. Ct. App. 1993). Fifteen years later, however, with the passage of the new Michigan Business Tax, effective beginning January 1, 2008, a taxpayer will have nexus in Michigan if it purposefully solicits persons within Michigan and generates gross receipts from Michigan of greater than $350,000. *See* M.C.L. § 208.1200(1) and Revenue Administration Bulletin 2008-4. Thus, the Michigan Department of Treasury now interprets the Supreme Court's holding in *Quill* to apply only to sales taxes, and has stated that "sub-

stantial nexus" includes economic nexus for purposes of the new Michigan Business Tax. *Id.*

This patchwork of rules imposes unnecessary burdens on interstate commerce.[8] Multistate taxpayers must now cope not only with complex state corporate income and franchise tax law but must engage in prolonged and costly legal battles against unchastened state tax administrators. Additionally, publicly traded corporations are now required to record a liability on their financial statements for income tax positions that are not supported by authority rising to a "more likely than not" level of assurance. This requirement forces taxpayers to deal directly with the consequences of uncertainty in the preparation of their financial statements.[9] Taxpayers and States would greatly benefit from clear guidance by this Court on this important issue. Although Congress "may be better qualified to resolve" this issue, *Quill,* 504 U.S. at 318, in the 17 years since *Quill*, Congress has repeatedly declined to enact limits on the States' ability to tax multistate business – or to lift the limits

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[8] "In a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777-78 (1992).

[9] *See* Financial Accounting Standards Board, Financial Accounting Series, No. 281-B, *FASB Interpretation No. 48–Accounting for Uncertainty in Income Taxes* (2006). FIN 48 was issued by the Financial Accounting Standards Board in July 2006 and is effective for fiscal years beginning after December 15, 2006.

this Court has imposed pursuant to the dormant Commerce Clause.[10]

Neither the Court nor the taxpayers should be surprised by the chip-chip-chip war of attrition that the States have engaged in since *Quill*. The same thing happened following the Court's decision in *National Bellas Hess*. Between 1967 and 1992, State after State engaged in wordplay and legislative sleight-of-hand to rationalize why the Commerce Clause holding of *National Bellas Hess* need not be followed.[11] Given the absence of congressional action, the reliance interest invoked in *Quill* – and chipped away by the States – should again be vivified by this Court.

III. DIFFERENT NEXUS STANDARDS FOR INCOME TAX PURPOSES AND SALES AND USE TAX PURPOSES ARE NOT JUSTIFIED

Those States that have moved away from the physical presence nexus standard have almost uniformly justified their departure by the Court's not expressly addressing the application of its holding to income taxes. This is the case even though the Court in *Quill* cautioned that its "silence" with respect to other taxes "does not imply repudiation of the [*National] Bellas Hess* rule." *Quill*, 504 U.S. at 314. While clever,

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[10] *See e.g.*, Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. (2009); Business Activity Tax Simplification Act of 2007, S. 1726, 110th Cong. (2007); Internet Fairness Act of 2001. H.R. 2526, 107th Cong. (2001); New Economy Fairness Act, S. 664, 107th Cong. (2001).

[11] *See* Laura A Kulwicki, *State Taxation of Mail Order Sellers: An End to the Nexus Wars?*, 1 State Tax Notes 332 (1991).

that interpretation of *Quill* lacks support in this Court's decisions.

Amicus TEI submits that there is no policy basis for distinguishing between the level of nexus required for sales and use tax purposes and that required for income tax purposes. To be sure, the objectives of the Commerce Clause are the same regardless of the type of tax; the focus is not on the form of tax but on the burdens it imposes. As for the lack of a direct holding on the appropriate income tax standard, *amicus* TEI suggests that it is historically due to acceptance of the principle that the same physical presence standard itself governs all taxes.

Indeed, ample grounds exist for concluding that the nexus requirement for income tax purposes is *more* demanding than the requirement for sales and use tax purposes. Unlike sales and use taxes, which are transaction-based, the authority to impose an income tax is predicated on a taxpayer's own links to the taxing jurisdiction – that is to say, whether the taxpayer is sufficiently present, or active, in the State (and derives sufficient benefits from the State) to satisfy the Constitution's minimum contacts requirement. The transactions being taxed under a sales and use taxing scheme are themselves a link between the taxpayer and the State, a connection that must be buttressed by the taxpayer's physical presence in order to survive constitutional scrutiny. Where the tax is imposed not on transactions but on income, an even-more-substantial connection is justified. Where the tax is imposed not on transactions but on a business's entire operations (potentially subject to apportionment), an even more substantial connection – physical presence – is constitutionally required.

One of the principal arguments made in support of a separate standard for sales and use taxes is that those taxes create a much more onerous compliance burden than other types of taxes. That is not the case. To be sure, this Court has recognized the burden of complying with sales and use tax rules in "the Nation's 6,000-plus taxing jurisdictions," *Quill*, 504 U.S. at 313 n.6, but multistate taxpayers also labor under weighty corporate income and franchise tax compliance burdens. Indeed, a 2002 study concluded that state income tax compliance costs are approximately double the costs of the federal burden,[12] in large measure because of differences among the States: "[S]tates differ in their reporting and filing procedures that determine which corporations must file a return, which related entities file together or separately, due dates for filing and paying taxes, and acceptance of federal extensions."[13] Some states require combined reporting, some States require the filing of a consolidated return, and other States allow separate reporting by each entity within an affiliated group.[14] While none of the compliance burdens occasioned by the wide variety of state income tax provisions may by itself be of constitutional moment, in combination with the amorphous economic nexus standard proposed by Massachusetts here they would dwarf the burdens of the various state sales and use taxes that the Court in *Quill* found to unduly burden interstate commerce in violation of the Commerce Clause.

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[12] Sanjay Gupta & Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, 56 National Tax J. 355-71 (June 2003).

[13] *Id.* at 358.

[14] *Id.*

In addition to corporate income taxes, many States impose franchise or net worth taxes on corporations that have nexus for state income tax purposes. The State of New York, for instance, imposes four different types of taxes on corporations with nexus in the State that all must be calculated as part of the filing of a single corporate income tax return. The heavy compliance responsibilities imposed on multistate taxpayers become crushing when the complexities associated with navigating the nexus labyrinth are added.

The development by States of new and diverse taxes also diminishes any justification that might exist for varying constitutional nexus standards. As States experiment with different types of taxes, the differences between sales taxes and other forms of taxation begin to blur. Examples of these new taxes include (1) Ohio's Commercial Activity Tax enacted in 2005 (based solely on gross receipts); (2) Michigan's Modified Gross Receipts Tax enacted in 2007 (based on gross receipts less certain purchases); and (3) Texas' Margin Tax enacted in 2007 (based on gross receipts less the greater of compensation, costs of goods sold or 30% of gross receipts). A clear standard for all taxes is critical. Permitting differing standards based on tax type would embolden States to continue considering alternative revenue raising methods to avoid the constitutional limits articulated in *Quill*. For example, a corporation whose activities in Michigan before the enactment of the Michigan Modified Gross Receipts Tax did not create nexus could now be subject to tax in Michigan if the constitutional limitations on nexus for an income tax and a gross receipts tax are different. The Court should take this opportunity occasioned by this case

to provide much needed guidance on this issue and to affirm the vitality of the physical presence test.

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of certiorari and reverse the decision below.

Respectfully submitted,

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In The
Supreme Court of the United States

CAPITAL ONE BANK (USA), N.A.,
F/K/A CAPITAL ONE BANK, AND CAPITAL ONE, N.A.,
AS SUCCESSOR TO CAPITAL ONE F.S.B.,

Petitioners,

v.

COMMISSIONER OF REVENUE
OF MASSACHUSETTS,

Respondent.

**On Petition For A Writ Of Certiorari
To The Supreme Judicial Court Of Massachusetts**

BRIEF OF THE COMMONWEALTH OF VIRGINIA, JOINED BY SOUTH DAKOTA, AS AMICI CURIAE IN SUPPORT OF GRANTING THE PETITION FOR CERTIORARI

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QUESTION PRESENTED

Whether the Supreme Judicial Court of Massachusetts erred in holding that a State may evade the "substantial nexus" requirement as explicated in *Quill* and *Bellas Hess* by imposing an income or excise tax on the very same out-of-state corporations that are constitutionally immune from sales and use taxes because they lack a physical presence in the taxing State.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

CASES

TABLE OF AUTHORITIES – Continued

TABLE OF AUTHORITIES – Continued

INTEREST OF AMICI[1]

The question presented in the petition is one of considerable importance and practical significance to the States. Under our constitutional design, the States bear the principal responsibility for the education, public safety, and transportation needs of the citizenry. Although States derive income from a variety of sources, taxes provide the lion's share of State revenues. Traditional taxation schemes have been battered by profound changes to the economy. These changes will prod States into reevaluating their taxation methods. Moreover, in the short and long-terms, States face growing challenges to align their spending commitments with their revenues. These challenges will provide further impetus for the States to reassess their revenue streams. In light of these challenges and pressures for taxation reform, the States need clarity in the law.

The amici States takes no position with respect to the underlying merits of the argument presented by Capital One. Rather, the States urge this Court to grant the petition so that the States can have the benefit of this Court's guidance regarding the "nexus" required by the Commerce Clause with respect to taxes imposed on an entity with no physical presence in a particular State.

[1] Counsel for Virginia, by written letter, has informed counsel for the parties of its intent to fiie this brief.

SUMMARY OF THE ARGUMENT

The Petition should be granted for three complementary reasons. First, the law is unclear. The lower courts are divided with respect to the "nexus" required under the Commerce Clause for a State to be able to impose a tax upon a corporation that lacks a physical presence in the State. Three state courts, including the lower court, uphold a tax based on a loose "nexus." An equal number of state court decisions cast doubt on these holdings. This uncertainty invites complex litigation and creates uncertainty concerning how States should reform their tax systems.

Second, the States have been, and will continue to be, compelled to reevaluate traditional taxation methods. The States are under great fiscal pressure due to the current recession. In the longer term, a growing gap between projected spending and projected revenues will force the States to consider new revenue streams, as well as cuts or changes in services. In addition, many state taxes are predicated upon increasingly superseded transactions for "brick and mortar" firms. The economy has undergone a profound transformation in recent decades and has moved away from these traditional business models. As the States consider what changes to make, the States need clarity in the law. At present, that clarity is missing.

Finally, the States need clarity because the consequences of an invalidated tax scheme, even one

enacted with the best of intentions, are profoundly disruptive to the States. If a state tax is found to be unconstitutional, the State loses the income stream from that tax. A State in that situation also must issue refunds for the improper taxes collected and deal with the ensuing morass of litigation. The consequences for guessing wrong on the required "nexus" could materially impact basic governmental functions.

ARGUMENT

I. THIS COURT SHOULD CLARIFY THE EXISTING UNCERTAINTY ABOUT ANY RESTRICTIONS THE COMMERCE CLAUSE IMPOSES ON A STATE ASSESSING A CORPORATE TAX IN THE ABSENCE OF A PHYSICAL PRESENCE.

In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), this Court examined the propriety of a use tax on a company that sold office equipment and supplies in North Dakota via catalog, flyers and direct telephone calls. *Id.* at 302. The company also shipped diskettes to some customers. *Id.* at 315 n.8. Drawing from its decision in *Nat'l Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967), this Court concluded that North Dakota's use tax placed an unconstitutional burden on interstate commerce because Quill had no meaningful physical presence within the State. *Quill Corp.*, 504 U.S. at 312-19. The Court also concluded that the "slightest

presence" of the diskettes in the State did not constitute the "'substantial nexus' requirement of the Commerce Clause." *Id.* at 315 n.8. The precise scope of this decision—whether it should be circumscribed to sales and use taxes, or whether it applies to other state business activity taxes—has become an issue of great importance for the States and for taxpayers.

Currently, "most states impose a financial institution tax (FIT) on all banks or other financial institutions." 1-5 Melanie J. McDaniel, BENDER'S STATE TAXATION: PRINCIPLES AND PRACTICE § 5.05 (2009). "The issue that has developed in the realm of financial institution taxation is what nexus concept a state applies when imposing its FIT on banks." *Id.* The lower courts are divided on this important question. A growing number of States have adopted an economic-nexus approach with respect to assessing their FITs.[2] Although the economic-nexus theory has been extensively litigated with respect to FITs, a decision in this case would have broad

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[2] *See Indiana Code* §§ 6-5.5-3-1, 6-5.5-3-4 (2006); *Kentucky Rev. Stat. Ann.* § 136.520 (2006); *Massachusetts Gen. Laws* ch. 63, § 1 (2006); *Minnesota Stat.* § 290.015 (2006); *West Virginia Code* § 11-24-7b (2006). Effective January 1, 2008, New York adopted an "economic-nexus" for banks engaging in credit card transactions in the State. *New York Tax Law* § 1451(c)(1) (2009). On May 1, 2008, Oregon similarly adopted a regulation permitting taxes on credit card activity in the State. Or. Admin. R. 150-317.010 (2008).

implications in other areas of business activity that are taxed by the States.[3]

Three state courts have embraced a narrow reading of this Court's decisions in *Quill* and *Bellas Hess*. The Supreme Judicial Court of Massachusetts held "the constitutionality, under the commerce clause, of the Commonwealth's imposition of the [Financial Institution Excise Tax] is determined not by *Quill's* physical presence test, but by the 'substantial nexus' test." *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76, 86 (Mass. 2009). The Supreme Court of West Virginia similarly concluded that *Quill* was limited to "sales and use taxes" and concluded that the "substantial nexus" required by the Commerce Clause could be satisfied by an "economic presence test." *Tax Comm'r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 234 (W. Va. 2006), *cert. denied sub nom. FIA Card Servs., N.A. v. Tax Comm'r of W. Va.*, 127 S. Ct. 2997 (2007). Finally, the Indiana Tax Court also concluded that *Quill* was limited to sales and use taxes and upheld Indiana's FIT based on a credit card company's "economic presence" in Indiana. *MBNA Am. Bank, N.A. v. Indiana Dep't of State Revenue*, 895 N.E.2d 140, 143-44 (2008).

[3] *See* Pet. 31-33 (describing the recent adoption of an "economic nexus" for various taxes in New Hampshire, Michigan, California, Maine, Florida, and Oregon).

The decisions of other courts, however, reject a narrow reading of *Quill* and *Bellas Hess* and call into question the holdings above. In *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), the Tennessee Court of Appeals concluded that a credit card issuer with no physical presence in the State could not be compelled to pay franchise and excise taxes. *Id.* at 842. The court concluded that *Quill* was controlling and could not be limited to sales and use taxes. *Id.* at 839-42. Similarly, the Texas Court of Appeals in examining a franchise tax, that "*Quill Corp.* and *Bellas Hess* should be limited to the context of sales and use taxes," rejected the argument. *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 299 (Tex. App. 2000). In that court's view, "no sufficient nexus exists to permit the state to assess [a] tax" in a situation where "the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state." *Id.* at 300. Finally, the Michigan Court of Appeals addressed the issue in examining whether certain activities by a corporation outside of the State of Michigan could establish a nexus between the corporation and those States sufficient to avoid the Michigan single business tax. *Guardian Indus. Corp. v. Dep't of Treasury*, 499 N.W.2d 349, 352-53 (Mich. Ct. App. 1993).[4] The court reasoned that, "after *Quill*,

[4] The single business tax was "a consumption type value-added tax." *Guardian*, 499 N.W.2d at 353. This tax was ultimately replaced in 2008 with the Michigan Business Tax. *See* Jeffrey Guilfoyle, Office of Revenue & Tax Analysis, Michigan Department

(Continued on following page)

it is abundantly clear that [a corporation] must show a physical presence within a target state to establish a substantial nexus to it." *Id.* at 356. The court remanded the case for further factual development with respect to the corporation's physical presence in other States. *Id.* at 357-58.

This uncertainty exposes the States to complex ongoing litigation and uncertainty as to the ultimate validity of taxes like the FIT. Eight years ago, one commentator discussed the matter and noted that "the U.S. Supreme Court will be asked to resolve the issue." R. Todd Ervin, Comment, *State Taxation of Financial Institutions: Will Physical Presence or Economic Presence Win the Day?* 19 Va. Tax Rev. 515, 516 (2000). One treatise in 2003 noted that this issue presents a "conflict of controlling state authority on a critical constitutional issue involving nothing less than the ability of the states to impose taxes among competing taxpayers on a level playing field. This is an issue that cries out for resolution which can only come from the highest court of the nation." Paul J. Hartman & Charles A. Trost, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION § 10:7 (2nd ed. 2003). In their 2008 supplement, the authors note that "the uncertainty continues." *Id.* (2008 Supp.). The time has come for this Court to grant certiorari and settle the question.

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of Treasury, *Overview of the Michigan Business Tax* (Sept. 2008). Available at: http://www.taxadmin.org/fta/meet/08rev_est/papers/guilfoyle2.pdf.

II. THE STATES NEED PREDICTABILITY AS THEY REASSESS THEIR INCOME STREAMS IN THE FACE OF SEVERE BUDGET PRESSURE AND A CHANGING ECONOMIC ENVIRONMENT.

A. The States face short-term and long-term budget pressures.

Present economic conditions impose great challenges to the state governments. The National Conference of State Legislatures noted in April 2008, in its State Budget Update, that, "[w]ith a few exceptions, state finances are deteriorating, in some cases considerably."[5] The situation certainly has not improved since that report was prepared. Even if the present economic crisis were to subside rapidly, the States face long-term budgetary stress. A recent Government Accountability Office report details some of these long-term challenges. U.S. GOV'T. ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENTS, GROWING FISCAL CHALLENGES WILL EMERGE DURING THE NEXT 10 YEARS (Jan. 2008).[6] The GAO report concludes that

> absent policy changes, state and local governments will face an increasing gap between receipts and expenditures in the coming years. Since most state and local governments actually face requirements that

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[5] Available at: http://www.ncsl.org/programs/fiscal/sbu2008 04.htm.

[6] Available at: http://www.gao.gov/new.items/d08317.pdf.

> their operating budgets be balanced or nearly balanced in most years, the declining fiscal conditions our simulations suggest are really just a foreshadowing of the extent to which these governments will need to make substantial policy changes to avoid these potential growing fiscal imbalances.

Id. at 5. Although there are a number of causes for this gap, the primary driver for increased expenditures is the cost of delivering health care, notably for the Medicaid program and the health benefits for state and local employees. *Id.* These "long-term fiscal challenges . . . are exacerbated by the current recession." U.S. GOV'T. ACCOUNTABILITY OFFICE, LETTER TO SEN. MAX BAUCUS, CHAIRMAN, AND CHARLES E. GRASSLEY, RANKING MEMBER, COMMITTEE ON FINANCE, UNITED STATES SENATE (Jan. 26, 2009).[7] To cover these expenditures, it is inevitable that many States, in addition to eliminating or cutting certain programs, will reassess their taxation schemes in an effort to pay for state services.

B. The changing nature of commerce will continue to prompt the States to reassess their income tax structures.

If the pressures described above did not suffice, fundamental changes to the economy make it more

[7] Available at: http://www.gao.gov/new.items/d09320r.pdf?source=ra.

likely that States will reevaluate their taxation methods. Until recently, most financial services were provided by small, local, or regional banks. Now, large national financial institutions provide all manner of services to the public, including credit cards, investment and brokerage services, and mortgages. Financial institutions routinely transact business with residents of a state in which the financial institution has no physical presence.

These long-term structural changes are not limited to the financial sector of the economy. Instead of transacting business with a local telephone company, some companies providing telecommunications services now have national reach and no physical presence in most states. The tremendous growth of commerce over the Internet is another fundamental change in the way transactions of all kinds are conducted. Sales over the Internet continue to grow at a strong pace, even in the current economic environment.[8]

All of these changes will continue to have profound effects on the way states tax. "The rapidly increasing extent of multistate activity appears to have dramatically lowered state sales and corporate income tax bases by making it difficult for states to collect taxes on remote sales and by allowing firms

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[8] *See* National Retail Federation, *Online Sales to Climb Despite Struggling Economy* (April 8, 2008). Available at: http://www.nrf.com/modules.php?name=News&op=viewlive&sp_id=499.

greater opportunities to shift income to low or no tax states." William F. Fox, *The Ongoing Evolution of State Revenue Systems*, 88 MARQ. L. REV. 19, 38 (2004). Inescapably, the States will "seek to fix their traditional taxes, and particularly the sales and corporate income taxes, to offset the weaknesses arising from the causes described above." *Id.* at 43. Given these pressures, many other States will no doubt consider whether to adopt similar measures. The question presented should be resolved *before* a broad conception of "nexus" becomes more deeply embedded in the tax regimes of the States.

III. PREDICTABILITY IS CRUCIALLY IMPORTANT TO THE STATES BECAUSE THE CONSEQUENCES OF AN INVALIDATED TAX ARE EXTREMELY DISRUPTIVE.

When a state tax is invalidated, the State will, of course, lose the income stream from the tax. Although some States have assembled a "rainy day" fund for certain contingencies, the limited resources in those funds may not be sufficient to cushion the blow. This particularly is true in the immediate future because state reserve funds currently are depleted. Furthermore, replacing the lost revenue stream with a new tax can take time due to the political process. Meanwhile, if the revenues are not quickly replaced, a State must reduce or eliminate services. Those most in need of services may bear the brunt of budget cuts. Furthermore, because most states have balanced

budget amendments, the option of deficit spending is not available.[9]

Adding to the loss of income are the lawsuits or refunds that follow in the wake of an invalidated tax. Thus, a State facing an invalidated tax faces a double blow. Not only does the State lose the income from that tax, it also must contend with refunds and lawsuits in connection with the invalidated tax scheme. Virginia experienced this situation when this Court invalidated Virginia's taxation of the retirement benefits of federal employees. *See Harper v. Virginia Department of Taxation*, 509 U.S. 86 (1993). At the time, refunds for approximately 200,000 claimants were estimated to total $470 million, at a time when Virginia faced a projected revenue shortfall of $700 million for its next biennium. *See* Lonnie Harp, *Tax Refund Ruling Clouds Fiscal Outlook for Some States*, EDUCATION WEEK (July 14, 1993).[10] The invalidation of a tax can be extraordinarily disruptive to a State.

States that do not presently rely upon the economic-nexus approach need this Court's guidance to gain an accurate and reliable understanding of what is and is not constitutionally permissible. The

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[9] *See* http://www.ncsl.org/programs/fiscal/balreqs.htm (discussing state balanced budget requirements).

[10] Available at: http://www.edweek.org/ew/articles/1993/07/14/41refund.h12.html. Ultimately, Virginia established a special fund and procedures to settle the claims. 1994 Va. Acts Spec. Sess. ch. 5.

States need this guidance *before* deciding whether to venture down that road and run the risk of subsequent invalidation, with all of the attendant disruption to revenues and services that this would entail.[11] The amici States ask this Court to grant certiorari to resolve the question presented.

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[11] A decision from this Court would also be beneficial for the States that have adopted an economic-nexus approach. Should the Court affirm the validity of the economic-nexus approach, it would forestall future challenges and place those taxes on a firm constitutional footing. If the Court invalidates business activity taxes based on an economic-nexus, given the clear trend toward the greater use of an economic-nexus approach in different areas of business activity taxation, the sooner the decision the less the potential for disruption.

CONCLUSION

For the reasons stated above, the Petition for Certiorari should be **GRANTED**.

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